

# Always Say Never: Tax Court Rejects IRS's Extreme Litigation Position in Penalty Cases

By Hale E. Sheppard

Hale E. Sheppard examines a recent Tax Court case, *Custom Stairs & Trim, Ltd., Inc.*, in which the IRS unsuccessfully argued that financial distress can “never” constitute reasonable cause for abating late payment and federal tax deposit penalties.

## Introduction

Nearly all taxpayers will face penalties by the IRS at some point, regardless of their sophistication level and size. Accordingly, tax practitioners, even those who claim not to get involved in traditional “collection” activities, must understand key aspects of abatement and collection procedures in order to effectively advise their clients. This is particularly true given that the IRS persists in taking extreme positions in the Tax Court, such as the always-say-never approach, that are contrary to the majority of existing legal authorities. A recent example is *Custom Stairs & Trim, Ltd., Inc.*,<sup>1</sup> a case in which the IRS unsuccessfully argued that financial distress caused by events beyond the taxpayer’s control can “never” constitute reasonable cause for abating late payment and federal tax deposit penalties. This taxpayer victory, a rarity in disputes of this nature, contains a number of valuable lessons for taxpayers and their advisors.

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## Key Aspects of Collection Due Process Hearings

To appreciate the importance of *Custom Stairs*, one must first have a basic understanding of collection due process (CDP) hearings, even if they would prefer not to.

Taxpayers often have troubles paying their taxes, and the situation has worsened in recent years as the economy continues to struggle and unemployment levels remain high. Given this reality, the IRS frequently finds itself taking forced collection actions, which include the use of federal tax liens and levies.

Within five days after filing a lien, the IRS must provide the affected taxpayer a Notice of Federal Tax Lien informing him of various things, including the amount of the tax liability and his right to request a CDP hearing within a limited period.<sup>2</sup> Likewise, the IRS is required to send the relevant taxpayer a Final Notice of Intent to Levy at least 30 days before it seizes his property to satisfy tax debts.<sup>3</sup> This, too, informs the taxpayer of his legal right to demand a CDP hearing. To contest either the tax lien or proposed levy, the taxpayer must file a timely Form 12153 (*Request for a Collection Due Process Hearing*) with the IRS. The taxpayer is entitled to raise “any relevant issue relating to the unpaid tax or the proposed levy”

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at the CDP hearing.<sup>4</sup> This includes challenges to the appropriateness of the IRS's collection activities, the applicability of innocent spouse relief and the taxpayer's entitlement to a payment alternative, such as offer-in-compromise and installment agreement.<sup>5</sup>

In cases where the taxpayer did not receive a Notice of Deficiency or otherwise have a prior opportunity to dispute an alleged tax liability, he can contest such liability at the CDP hearing, too.<sup>6</sup> The regulations expand on this notion, stating that "[t]he taxpayer also may raise challenges to the existence or amount of the underlying liability, including a liability on a self-filed return, for any tax period specified in the CDP Notice if the taxpayer did not receive a statutory notice of deficiency for that tax liability or did not otherwise have an opportunity to dispute the tax liability."<sup>7</sup>

The Appeals Officer conducting the CDP hearing is charged with deciding whether the IRS's lien or proposed levy "balances the need for efficient collection of taxes with the legitimate concern of the person that any collection action be no more intrusive than necessary."<sup>8</sup> It should come as no surprise to tax practitioners that the Appeals Officer often concludes that the need for swift tax collection prevails. In such cases, the Appeals Officer issues a so-called Notice of Determination upholding the lien or levy.

Down, but not altogether out, the taxpayer still has the right to seek further review, this time from the judiciary. If the taxpayer is dissatisfied with the holdings in the Notice of Determination, he can file a petition with the U.S. Tax Court.<sup>9</sup>

## **Financial Distress as Reasonable Cause for Penalty Abatement**

As explained later in this article, one of the main issues in *Custom Stairs* is whether "financial distress" constitutes reasonable cause for penalty abatement. The tax code, Internal Revenue Manual (IRM) and tax regulations all indicate that it can under certain circumstances.

Under Code Sec. 6651, the IRS may generally assert so-called "delinquency" penalties if a taxpayer fails to file certain returns and/or pay the corresponding taxes by the deadline. Moreover, pursuant to Code Sec. 6656, the IRS may assert federal tax deposit (FTD) penalties if a taxpayer fails to pay employment taxes in full, on time and in the manner required. The IRS cannot impose these sanctions, however, if the taxpayer manages to show that the noncompliance was due to "reasonable cause" and not due to "willful neglect."<sup>10</sup>

The IRM contemplates reasonable cause in situations where the taxpayer's justification for late payment is tough economic times. On this note, the IRS adopted an official "policy statement" over 40 years ago, in 1970, to the effect that "lack of funds" constitutes reasonable cause for penalty abatement, as long as the taxpayer shows that the shortage happened even though the taxpayer used ordinary business care and prudence.<sup>11</sup>

The tax regulations also identify a bad economy as a potential reason for abatement. Portions of the relevant regulations are set forth below:

A failure to pay will be considered to be due to reasonable cause to the extent that the taxpayer has made a satisfactory showing that he exercised ordinary business care and prudence in providing for payment of his tax liability and was nevertheless either unable to pay the tax or would suffer an undue hardship ... if he paid on the due date.

[C]onsideration will be given to all the facts and circumstances of the taxpayer's financial situation, including the amount and nature of the taxpayer's expenditures in light of the income (or other amounts) he could, at the time of such expenditures, reasonably expect to receive prior to the date prescribed for the payment of the tax.

A taxpayer will be considered to have exercised ordinary business care and prudence if he made reasonable efforts to conserve sufficient assets in marketable form to satisfy his tax liability and nevertheless was unable to pay all or a portion of the tax when it became due.<sup>12</sup>

The regulations clarify that the IRS may be more stringent with trust fund items (such as employment taxes) than with income taxes; that is, the IRS will take into consideration the type of tax at issue in determining whether it was reasonable for a taxpayer to pay late.<sup>13</sup> In this regard, the regulations declare that facts and circumstances constituting reasonable cause for non-payment of income taxes may not represent reasonable cause for failure to pay over to the IRS taxes withheld from other persons (*i.e.*, trust fund taxes).<sup>14</sup>

## **Analysis of the Most Recent Financial Distress Case**

The taxpayer in *Customs Stairs*, a company devoted to building wooden staircases for residential proper-

ties along the Gulf Coast, was located in Pensacola, Florida. The company had been operating successfully, and paying all of its taxes in a timely manner, since its inception in 1985. The trouble began in September 2004, when Hurricane Ivan struck the Gulf Coast. It severely damaged the company's place of business and negatively impacted many of its customers. Had Hurricane Ivan constituted the sole problem, the company might have weathered the storm, so to speak. The challenge, though, was that the company faced three obstacles simultaneously: the devastation caused by Hurricane Ivan, the collapses of the housing bubble in the region and the onset of the nationwide economic recession.

The company did not surrender amid these bad circumstances; rather, it took steps to salvage its operations. For instance, it laid off certain employees, eliminated vacations and paid holidays for the workers that remained, reduced other employee benefits and even contacted a real estate broker in an attempt to sell its office property to raise cash. The owners of the company did their part, too, by investing personal funds, including credit card charges, to cover essential business expenses. Despite these efforts, the company fell behind on its employment taxes, and the IRS asserted delinquency penalties and/or FTD penalties for various quarters in 2005, 2006, 2007 and 2008.

As is customary with employment taxes, the IRS assigned a Revenue Officer to the case in July 2008. The Revenue Officer asked the company to provide financial data, such that the IRS could determine, among other things, whether the company was eligible to enter into a payment plan (*i.e.*, installment agreement) with the IRS. The company believed that it could pay all past tax liabilities within two months and expressed as much to the Revenue Officer. Accordingly, the Revenue Officer agreed to postpone additional collection actions until then. The Revenue Officer later granted the company two more short extensions, which leniency was surely do to the company's positive actions. Indeed, the Revenue Officer noted in her records that the company was (1) fully meeting its employment tax filing and payment obligations for the current periods, (2) showing "swift progress" on reducing past-due liabilities, (3) maintaining communications with the IRS about the collection issues, and (4) making earnest efforts during a poor economic cycle for home construction.

The company managed to resolve all past issues with the IRS by late November 2008, except a minor liability for one tax period—second quarter 2008. The Revenue

Officer, likely pressured by her superiors, finally filed a lien and sent the company the requisite Notice of Federal Tax Lien. In response, the company filed a timely Form 12153 requesting a CDP hearing and seeking a lien "withdrawal." The tax code and corresponding regulations allow for the IRS to "withdraw" a lien (and act as if it had never been filed) in certain circumstances, such as when the filing of the lien was premature.<sup>15</sup> The company's argument can be summarized as follows: the company already paid all the underlying employment taxes, penalties, and interest for all quarters except one; the company also paid the taxes for the one pending quarter; the only remaining issue was the penalty for one quarter; the company had reasonable cause for the late payment of taxes for such quarter (*i.e.*, financial distress), so the penalty should be abated; once the penalties disappear, there is no liability; and filing a federal tax lien when no liability exists is premature.

Predictably, the Settlement Officer conducting the CDP hearing rejected the company's argument and determined that there was no reasonable cause for penalty abatement. He thus issued a Notice of Determination indicating that the Notice of Federal Tax Lien was not premature and should not be withdrawn. The company, dissatisfied with this outcome, filed a timely Petition with the Tax Court.

The Tax Court began its Opinion with an overview of the procedural aspects of CDP hearings. Then, citing a case well known to those who spend time in the collection arena, *Montgomery*, the Tax Court confirmed that the company was entitled to address the issue at hand, the delinquency and FTD penalties stemming from an employment tax liability.<sup>16</sup> In this regard, the Tax Court explained that the IRS "has not shown, indicated, or alleged that [the company] had an opportunity to dispute the tax liability, and the penalty was related to a liability that was self-reported as due on the return. Consequently, the underlying liability is properly at issue." The Tax Court further built on this concept, clarifying that in cases where the taxpayer's liability is in question, the Tax Court reviews any administrative determination by the IRS under the *de novo* standard, as opposed to the abuse-of-discretion standard.

With those preliminary yet critical issues resolved, the Tax Court addressed the substance of the case. It summarized the parties' positions as follows. The company argued that it experienced financial distress from 2005 through 2008 as a result of Hurricane Ivan, the collapse of the housing bubble and the economic recession. Because of these events, the company could not fully pay both its tax obligations

and its crucial operating expenses. This inability to pay, concluded the company, represents reasonable cause for penalty abatement.

For its part, the IRS maintained that the mere inability to pay, coupled with the company's payment of other creditors instead of the IRS, can *never* constitute reasonable cause for abatement of employment tax penalties. This argument, frequently raised by the IRS at trial, is rooted in the atypical decision by the Sixth Circuit Court of Appeals in *Brewery* back in 1994 that "financial difficulties can never constitute reasonable cause to excuse the penalties for nonpayment of withholding taxes by an employer."<sup>17</sup> The IRS further noted in *Custom Stairs* that the company was not a first-time offender, having paid late in nearly 15 tax periods in 2005, 2006, 2007 and 2008.

The Tax Court immediately rejected the IRS's principal argument, explaining that the financial-distress-can-never-under-any-circumstances-constitute-reasonable-cause contention has been rejected by the majority of the federal Courts of Appeal. It also pointed out that the IRS's own guidance, the sacred IRM, specifically states that financial distress can indeed equate to reasonable cause in certain circumstances.

Thus dispensing with the IRS's main position, the Tax Court then analyzed whether the circumstances in *Custom Stairs* were sufficiently unique to warrant penalty abatement and, by extension, lien withdrawal. The Tax Court looked to the regulations under Code Sec. 6651 (related to delinquency penalties) because the regulations under Code Sec. 6656 (related to federal tax deposit penalties) only address reasonable cause in the context of first-time depositors. It focused on the language that reasonable cause exists where a taxpayer exercised ordinary business care and prudence and, nevertheless, could not pay the taxes because the taxpayer simply lacked sufficient funds or could pay the taxes, but doing would have triggered undue financial hardship. In determining whether a taxpayer has met the preceding standard, the Tax Court indicated that the Courts of Appeals have examined the following factors: (1) the taxpayer favoring other creditors over the IRS, (2) a history of failing to make timely tax deposits, (3) the taxpayer's financial decisions, and (4) the taxpayer's willingness to decrease expenses and personnel.

The Tax Court ultimately found in the company's favor, holding that there was reasonable cause for the late employment tax payments. The Tax Court underscored a number of issues in arriving at this taxpayer-favorable decision in *Custom Stairs*. First,

the Tax Court recognized that late payments were largely attributable to events beyond the company's control, namely, the effects of Hurricane Ivan, the decrease in residential housing construction, and the economic recession.

Second, the Tax Court noted throughout the case that the company had made significant efforts to resolve the issues quickly, such as terminating workers, reducing the benefits of the remaining workers, attempting to sell its office property and having the company's owners invest personal funds to keep the company afloat during tough times.

Third, the Tax Court found great fault with the IRS's position that "if [the company] cannot afford to make its tax payments timely it should go out of business." Citing precedent from the Third Circuit Court of Appeals, the Tax Court noted that, under the IRS's theory, absolutely nobody wins, as both the general economy and the IRS's coffers would be negatively impacted by an approach triggering increased unemployment, idle business facilities and decreased sales of goods and services.

Finally, the Tax Court made multiple references to the fact that the IRS exacerbated the problem for the company. Like many taxpayers, the company in *Custom Stairs* apparently failed to properly designate its voluntary payments to the IRS. This allowed the IRS to apply the payments in a manner most favorable to itself, which is the normally the manner most unfavorable to the company. As the Tax Court recognized in another case, "[i]f a taxpayer makes a voluntary payment without directing the application of the funds, the IRS may make whatever allocation it chooses" and "[t]he taxpayer does have a right to direct his or her voluntary payment but must make the request or designation how the money is to be applied."<sup>18</sup> The Tax Court in *Custom Stairs* acknowledged that the IRS had the right to apply the undesignated payments in an IRS-friendly manner, yet made it known that such allocation played a role in its decision to grant penalty abatement:

For most of these quarters [the company] actually paid over to the [IRS] amounts that would have fully satisfied its liability for the current quarter; but the IRS applied its payments to prior arrearages, leaving all or portions of each successive quarter's required deposits underpaid.

Quarter after quarter current funds were used to pay then-assessed penalties for the prior quarter at the costs of not making all timely deposits for the current quarter.



[The company] failed to allocate to its own advantage the payments that it made, and the IRS cannot be criticized for making its own allocation to prior quarters; but during the relevant time period [the company's] lapse was its failure to have paid in prior quarters and its failure to allocate, not any current failure to pay over to the IRS the tax it had withheld from its employees.

## What *Custom Stairs* Teaches Taxpayers and Tax Professionals

Clichéd though it may sound, sometimes big things come in small packages. This is true with *Custom Stairs*, where the entire amount at issue during the CDP hearing and later at trial was \$3,125 in FTD penalties and \$225 late-payment penalties, along with minor interest charges and collection fees.<sup>19</sup> Notwithstanding the relatively small amounts in play, *Custom Stairs* should teach taxpayers and their advisors several important lessons.

### *Custom Stairs* Represents One of Few Taxpayer Victories

Consistent with the express language in Code Secs. 6651 and 6656, the IRS's policy featured in the IRM, and the relevant tax regulations, numerous courts at various levels (*i.e.*, federal district courts, courts of appeals and bankruptcy courts) have recognized that an economic recession or other event causing unforeseen financial difficulties may constitute reasonable cause.<sup>20</sup> However, since "[a]lmost every non-willful failure to pay taxes is the result of financial difficulties," taxpayers frequently raise the financial-distress-equals-reasonable-cause argument at trial.<sup>21</sup> They frequently lose, too, thereby creating a long line of unfavorable legal precedent for other taxpayers.

Few cases exist where the taxpayer achieves victory thanks to the financial distress defense. The five most notable are *Glenwal-Schmidt*,<sup>22</sup> *In re Pool & Varga, Inc.*,<sup>23</sup> *In re Arthur's Industrial Maintenance, Inc.*,<sup>24</sup> *In re Slater Corporation*<sup>25</sup> and *East Wind Industries, Inc.*<sup>26</sup> All penalty abatement cases, and the preceding five are no exception, are fact intensive affairs, with no two being exactly alike. With that said, one court, based on its review of all judicial precedent existing as of 2004, identified the following guidelines: Courts are more inclined to find that financial difficulties warrant penalty abatement when (1) a real choice existed between making payments to the IRS and going out of business, (2) the taxpayer believed that the crisis would be alleviated by the occurrence of

one or more specific contingencies, (3) the duration of the financial crisis was limited, (4) the taxpayer did not unfairly favor other creditors over the IRS, (5) personal resources were contributed to avoid business collapse, and (6) the taxpayer was neither unjustly enriching itself nor its owners.<sup>27</sup>

The holding in *Custom Stairs* ratifies the list of guidelines above and provides taxpayers with favorable precedent in an area where it is scarce.

### *Customs Stairs* Reveals IRS Inconsistencies in Collection Matters

The IRS has publicly committed itself to assisting beleaguered taxpayers. According to a recent report by the Treasury Inspector General for Tax Administration (TIGTA), the IRS took a proactive approach in late 2008 by establishing teams and tasking them with determining what additional actions the IRS could take to assist taxpayers facing economic challenges.<sup>28</sup> The ideas generated by these teams were initially summarized in the so-called "Economic Challenges Action Plan."<sup>29</sup>

The TIGTA report identifies as one of the IRS's major communication efforts a news release in January 2009, which highlighted several steps that the IRS intended to take. These included (1) increasing the period for terminating an installment agreement from 30 days to 60 days after a taxpayer misses a scheduled payment; (2) obtaining an independent review of home-value information where such value is the only issue impeding the IRS's acceptance of a taxpayer's settlement offer; (3) temporarily postponing collection action without reviewing full financial documentation in situations where the taxpayer has recently lost a job, relies solely on Social Security payments, and/or faces significant medical bills; and (4) introducing expedited levy release procedures where the levy is causing an economic hardship for the taxpayer.<sup>30</sup> The news release in January 2009 also contained several pro-taxpayer comments by the IRS Commissioner, such as "we are creating new protections to help people trying to meet their tax obligations," "the IRS will do everything it can during these tough times," and "we want to go that extra mile to help taxpayers, especially those who've done the right thing in the past and are facing unusual hardships."<sup>31</sup>

As expected, the development of the Economic Challenges Action Plan and issuance of the IRS news release coincided with a congressional hearing in February 2009. The event, which was aptly named "Hearing on IRS Assistance for Taxpayers Experiencing Economic Difficulties," benefitted from contributions

by several high-ranking IRS officials and other experts. During the hearing, both the IRS Commissioner and the Deputy Commissioner for Services and Enforcement recognized that the IRS should adjust its methods during the current economic crisis. Together, their words contain little ambiguity in this regard:

Our effort to assist taxpayers during these difficult times is a confirmation of part of the IRS' core mission, which is to assist taxpayers in any way possible to meet their obligations ... The IRS is committed to assisting America's taxpayers in any way it can during this difficult time. We understand that given the fragile state of the economy and the financial duress of many individuals, we may need to go even further. You have my commitment and that of Commissioner Shulman to work closely with you as we move forward.<sup>32</sup>

[I]t is inevitable that during an economic downturn, taxpayers may fall behind in paying their taxes. As IRS Commissioner, I am committed to striking the right balance between collecting the revenues needed to fund the government, and using all the tools available to us to work with taxpayers who find themselves in difficult financial situations.<sup>33</sup>

The IRS's official tune has not changed over time. Indeed, the IRS issued another news release in March 2010. Like the earlier release in January 2009, this one was replete with pro-taxpayer statements from IRS leadership, including "times are tough for many people, and the IRS wants to do everything it can to help people who have lost their job or face financial strain" and "we're doing everything we can to help ease the burden on struggling taxpayers."<sup>34</sup>

*Custom Stairs* reveals that the IRS's public position, as described above, seems entirely inconsistent with its private position. An objective person must acknowledge that the company in *Custom Stairs* counted on sympathetic facts: it had a 20-year history of full tax compliance; the tax troubles sprang from events beyond its control (*i.e.*, Hurricane Ivan, the housing bust and widespread economic recession); it implemented various cost-cutting measures; it made "swift progress" on paying its past liabilities while eventually accomplishing full compliance with current tax obligations; it communicated and cooperated with the Revenue Officer assigned to the case; and it ultimately paid all back taxes, penalties and interest, except a minor amount for one quarter. Seemingly oblivious to these

compelling facts, the IRS's own public position (as announced recently to Congress and others) about helping downtrodden taxpayers, the express legal authority for the financial-distress defense found in various tax regulations and the fact that the majority of the federal Court of Appeals have rejected the IRS's extreme position, the IRS advanced the argument that *Custom Stairs* that financial distress can "never" constitute reasonable cause for penalty abatement.

### ***Custom Stairs* Confirms When and Where Taxpayers Can Fight Penalties**

Congress created the Tax Court under Article I of the U.S. Constitution.<sup>35</sup> Accordingly, it is a court of limited jurisdiction, restricted to resolving those types of issues specifically identified by Congress.<sup>36</sup> Employment tax matters, which are not subject to deficiency procedures applicable to income, gift, estate and other types of taxes, do not normally fall within the purview of the Tax Court.<sup>37</sup> Consequently, employment tax disputes ordinarily occur as refund actions in the proper U.S. District Court. *Custom Stairs* offers some unconventional thinking on this issue, though.

As explained above, Code Sec. 6330(c)(3) provides that taxpayers who are not entitled to receive a Notice of Deficiency (which would give them a chance to dispute any proposed tax increase before the assessment thereof) or who are not otherwise been afforded an opportunity to dispute an alleged liability before collection actions commence can challenge at the CDP hearing the "underlying tax liability;" that is, the existence or amount of the liability. The relevant regulations broaden this right, specifying that such taxpayers can even contest the liability "on a self-filed return."<sup>38</sup> The scope of "underlying tax liability" is not clarified in the Code or legislative history, but case law establishes that this phrase, at least in the context of Code Sec. 6230 (federal tax lien) and Code Sec. 6330 (federal tax levy), encompasses the tax deficiency, *and* penalties, *and* interest.<sup>39</sup> Based on the preceding, the company in *Custom Stairs* was authorized to contest just the penalties, originating in the employment tax returns, during the CDP hearing and later in Tax Court.

This procedural anomaly should be interesting to taxpayers and practitioners, who often face hurdles in getting into their preferred tax-dispute forum, the Tax Court, on penalty issues. The following should put the issue into perspective. Assume that a taxpayer files a timely, accurate tax return, but lacks the funds necessary to pay the entire liability shown on the

return. In such cases, the IRS will assert delinquency penalties under Code Sec. 6651 and send the taxpayer a notice thereof. A taxpayer could then file a penalty abatement request under Code Sec. 6404, which authorizes the IRS to reduce or eliminate any assessment that is excessive, late, erroneous or illegal. If the IRS were to deny the abatement request, the taxpayer could file an administrative appeal, asking the IRS Appeals Office to review the matter. With the exception of requests for *interest* abatement, the taxpayer has no recourse to the Tax Court in situations where the Appeals Office seconds the abatement denial.<sup>40</sup> Sure, the taxpayer could pay the penalties and then initiate a refund action, but that is often a time-consuming and extremely costly endeavor.

The preceding example poses the question of when, exactly, a taxpayer should challenge a penalty. In cases involving employment tax returns, which are not subject to the standard deficiency procedures, and other returns where penalties are the sole issue, *Custom Stairs* may influence taxpayers to wait and pursue the matter during the CDP process, as opposed to being proactive early by filing a formal abatement request under Code Sec. 6404.

### **Customs Stairs Confirms Proper Standard of Review by Tax Court**

Discussions about jurisdictional issues and standards of review can be tedious, even to the most avid fans of legal procedure. However, these issues are critical to taxpayers, like the one in *Custom Stairs*, facing collection actions by the IRS.

Let's review the relevant facts from *Custom Stairs*. The company filed a timely Form 941 for the second quarter 2008 reporting its employment tax liability for such period, but it failed to pay the entire tax liability at that time. Consequently, the IRS asserted penalties. After the IRS filed its Notice of Tax Lien, the company filed a Form 12153 requesting a CDP hearing solely to contest the penalties, and, by extension, the lien based on such penalties. The company disputed the penalties during the CDP hearing, and when the IRS rejected its arguments at that level, the company raised the same issue in its Petition to the Tax Court.

As explained in the preceding segment of this article, under Code Sec. 6330(c)(3) and the corresponding regulations, the company in *Custom Stairs* was entitled to raise the penalty issue during the CDP hearing because the penalties were considered part of the "underlying tax liability"

for these purposes. At trial, the Tax Court did not analyze the jurisdictional issue, simply stating that the IRS did not show, indicate or otherwise allege that the company had a prior opportunity to dispute the tax liability (*i.e.*, the penalties), and the penalties were related to the employment tax liability that was self-reported on the Form 941. Therefore, concluded the Tax Court, the penalties were properly at issue at trial.

While few people probably noticed, the Tax Court also noted that if a taxpayer's underlying tax liability is properly at issue, then the Tax Court reviews it *de novo*, not applying the abuse-of-discretion standard. To appreciate this distinction and how favorable it can be to taxpayers, one must first consult the applicable definitions. The phrase "abuse of discretion" means the following:

[A] failure to exercise a sound, reasonable, and legal discretion ... A discretion exercised to an end or purpose not justified by and clearly against reasons and evidence ... A judgment or decision by an administrative agency or judge which has no foundation in fact or law ... [A]ny unreasonable, unconscionable and arbitrary action taken without proper consideration of facts and law pertaining to matter submitted.<sup>41</sup>

Accordingly, when the Tax Court reviews an earlier decision by the IRS under the abuse-of-discretion standard, it must uphold the prior administrative determination unless it was, well, pretty awful. The Tax Court would need to conclude that the IRS either outright failed to exercise the discretion granted to it by Congress or exercised it in a way that was entirely unreasonable, unconscionable, ungrounded, unsound, etc.

The other term, "de novo," has a different connotation. If the Tax Court is hearing a case *de novo*, it is "[t]rying matter anew the same as if it had not been heard before and as if no decision had been previously rendered."<sup>42</sup> Thus, the Tax Court is not restricted to evaluating whether the IRS came to a reasonable analysis; rather, it is permitted to substitute its own judgment altogether.

### **Conclusion**

Insanity, according to Albert Einstein, is doing the same thing over and over and expecting different results. This makes sense, given that people ordinarily use the trial-and-error approach, refining their methodologies



as they go. The IRS, though, continues to take extreme positions before the Tax Court, such as financial distress can “never” represent grounds for penalty abatement, that have repeatedly been rejected by the courts, with one glaring exception years ago. In light

of this reality, and the fact that taxpayers are likely to continue incurring significant tax penalties as the national economy slumps, taxpayers and their advisors should be aware of the recent decision in *Custom Stairs* and the taxpayer-favorable lessons it teaches.

### ENDNOTES

- <sup>1</sup> *Custom Stairs & Trim, Ltd., Inc.*, 102 TCM 1, Dec. 58,687(M), TC Memo. 2011-155.
- <sup>2</sup> Code Sec. 6320(a).
- <sup>3</sup> Code Sec. 6330(a).
- <sup>4</sup> Code Sec. 6330(c)(2)(A).
- <sup>5</sup> Code Sec. 6330(c)(2)(A).
- <sup>6</sup> Code Sec. 6330(c)(3).
- <sup>7</sup> Reg. §301.6320-1(e)(1); Reg. §301.6320-1(e)(3) Q-E2 and A-E2.
- <sup>8</sup> Conference Report 105-599, 105<sup>th</sup> Cong., 2d Sess., June 24, 1998, p. 263; Code Sec. 6330(c)(3)(C).
- <sup>9</sup> Code Sec. 6330(d); U.S. Tax Court Rule 331(b). This petition is called a “Petition for Lien or Levy Action Under Section 6320(c) or 6330(d),” as applicable.
- <sup>10</sup> Code Sec. 6651(a); Reg. §301.6651-1(a)(1); Code Sec. 6656(a).
- <sup>11</sup> IRM § 1.2.1.3.3 (Dec. 29, 1970) (IRS Policy Statement P-2-7).
- <sup>12</sup> Reg. §301.6651-1(c)(1). See also, Reg. §1.6161-1(b), which explains that the term “undue hardship” means more than an inconvenience to the taxpayer. It must appear that substantial financial loss (e.g., loss due to the sale of property at a sacrifice price) will result to the taxpayer for making tax payments on time.
- <sup>13</sup> Reg. §301.6651-1(c)(2).
- <sup>14</sup> Reg. §301.6651-1(c)(2).
- <sup>15</sup> Code Sec. 6323(j)(1)(A); Reg. §301.6323(j)-1(b)(1).
- <sup>16</sup> *N. Montgomery*, 122 TC 1, Dec. 55,501 (2004).
- <sup>17</sup> *Brewery Inc.*, CA-6, 94-2 USTC ¶50,435, 33 F3d 589.
- <sup>18</sup> *D.F. Pace*, 80TCM 417, Dec. 54,056(M), TC Memo. 2000-300.
- <sup>19</sup> *Supra* note 1 at fn. 3. The disputed amount was even smaller at the time of trial because of another voluntary payment by the company.
- <sup>20</sup> See, e.g., *C.E. Wolfe*, DC-MT, 85-2 USTC ¶9476, 612 FSupp 605, *aff’d*, CA-9, 86-2 USTC ¶9655, 798 F2d 1241, 806 F2d 1410; *Rogers*, 66 A.F.T.R.2d 90-5831 (E.D. Mi. 1990); *Upton Printing Company*, BC-DC-LA, 95-2 USTC ¶50,377, 186 BR 904; *Sykes & Sons, Inc.*, BC-DC-PA, 95-2 USTC ¶50,620, 188 BR 507; *Frederick Savage, Inc.*, BC-DC-FL, 95-1 USTC ¶50,189, 179 BR 342; *Bostar Foods, Inc.*, 79 A.F.T.R.2d 97-1041 (W.D. Ky. 1997); *Van Camp & Bennion*, CA-9, 2001-1 USTC ¶50,446, 251 F3d 862; *Fran Corp.*, CA-2, 99-1 USTC ¶50,208, 164 F3d 814; *Diamond Plating Company, CA-7*, 2005-1 USTC ¶50,107, 390 F3d 1035; *Harvey & Sons, Co. v. IRS*, 94 A.F.T.R.2d 2004-7258 (D. Mass. 2004); *Burt, Inc. v. IRS*, 99 A.F.T.R.2d 2007-1856 (N.D. Ind. 2007).
- <sup>21</sup> *Wolfe, id.*, 612 F. Supp., at 608.
- <sup>22</sup> *Glenwal-Schmidt*, 42 A.F.T.R.2d 78-5817 (D.D.C. 1978).
- <sup>23</sup> *Pool & Varga, Inc.*, DC-MI, 86-1 USTC ¶9445, 60 BR 722.
- <sup>24</sup> *Arthur’s Industrial Maintenance, Inc.*, 71 A.F.T.R.2d 93-4437 (Bkrcty W.D. Va. 1992).
- <sup>25</sup> *Slater Corp.*, BC-DC-FL, 96-1 USTC ¶50,043, 190 BR 695.
- <sup>26</sup> *East Wind Industries, Inc.*, CA-3, 99-2 USTC ¶50,968, 196 F3d 499.
- <sup>27</sup> *Harvey & Sons, Inc.*, 94 A.F.T.R.2d 2004-7258, at \*14 (D. Mass 2004).
- <sup>28</sup> Treasury Inspect General for Tax Administration. “Collection Alternatives Were Available to Economically Distressed Taxpayers, but Some New Processes Need Improvement.” Report No. 2010-30-032 (March 15, 2010), pg. 2.
- <sup>29</sup> *Id.*
- <sup>30</sup> *Id.* at 3-4; IRS News Release IR-2009-2, Jan. 6, 2009, “IRS Begins Tax Season 2009 with Steps to Help Financially Distressed Taxpayers; Promotes Credits, e-File Options.”
- <sup>31</sup> IRS News Release IR-2009-02, Jan. 6, 2009, “IRS Begins Tax Season 2009 with Steps to Help Financially Distressed Taxpayers; Promotes Credits, e-File Options.”
- <sup>32</sup> Hearing on IRS Assistance for Taxpayers Experiencing Economic Difficulties. U.S. House of Representatives, Committee on Ways & Means, Subcommittee on Oversight. Written Statement by Linda E. Stiff, IRS Deputy Commissioner for Services and Enforcement (Feb. 26, 2009).
- <sup>33</sup> Hearing on Internal Revenue Service Operations and Fiscal Year 2010 Budget Proposals. U.S. House of Representatives, Committee on Ways & Means, Subcommittee on Oversight. Written Statement by Douglas Shulman, IRS Commissioner (June 4, 2009).
- <sup>34</sup> IRS News Release 2010-29 (March 9, 2010), “IRS Outlines Additional Steps to Assist Unemployed Taxpayers and Others.”
- <sup>35</sup> Code Sec. 7441.
- <sup>36</sup> Code Sec. 7422.
- <sup>37</sup> Code Sec. 6212.
- <sup>38</sup> Reg. §301.6320-1(e)(1); Reg. §301.6320-1(e)(3) Q-E2 and A-E2; *Supra* note 16.
- <sup>39</sup> See *S.W. Katz*, 115 TC 329, Dec. 54,081 (2000); *Supra* note 16; *R.T. Lites*, 90 TCM 191, Dec. 56,130(M), TC Memo. 2005-206; *P.B. Westcott*, 99 TCM 1150, Dec. 58,143(M), TC Memo. 2010-36; *D.K. Shaw*, 100 TCM 292, Dec. 58,344(M), TC Memo. 2010-210.
- <sup>40</sup> Code Sec. 6404(h).
- <sup>41</sup> Henry Campbell Black, *BLACK’S LAW DICTIONARY*, at 10-11 (6<sup>th</sup> ed. 1990).
- <sup>42</sup> *Id.*, at 721.

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