

IN CASE YOU MISSED IT – January 2025

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Almost every day, federal and state courts issue opinions that affect taxpayers. The IRS and state taxing authorities also publish guidance on a myriad of topics.

Each month, this column will review a selection of recent court cases or guidance that tax professionals should know about when advising their clients and preparing tax returns.

For more extensive details on any of these items, please feel free to reach out to the author.

[Adams](#) – No third bite at the apple

In 2015, Congress provided the IRS with another weapon for its collection arsenal, enacting [Code section 7345](#) as part of the Fixing America's Surface Transportation Act. This provision allows the Commissioner to certify to the Secretary of State that an individual has a seriously delinquent tax debt and request that the Secretary of State deny, revoke, or limit the taxpayer's passport.

Section 7345 defines a seriously delinquent tax debt as an "unpaid, legally enforceable federal tax liability of an individual" that i) has been assessed; ii) exceeds \$50,000; and iii) for which the IRS must have either (i) filed a notice of lien pursuant to [Code section 6323](#) and waited for the taxpayer's administrative rights under [Code section 6320](#) to be exhausted or lapse or (ii) made a levy under [Code section 6331](#).

The taxpayer has the right to dispute whether the certification to the Secretary of State is erroneous in court [Code section 7345(e)]. In this case, however, Taxpayer attempted to dispute the validity of the underlying assessment in his certification fight.

As you should recall, after the IRS determines that a taxpayer has a tax deficiency, it must mail a notice of deficiency by certified or registered mail to the taxpayer, notifying them of the proposed change. If the taxpayer does not lodge a dispute with the findings in the notice of deficiency by timely filing a petition in the Tax Court, the IRS can then assess the deficiency. The IRS must also mail a notice of the assessment to the taxpayer.

Once the assessment is final, the IRS can begin the collection process. In addition to simply sending out bills, the IRS can send the taxpayer a notice of federal tax lien or a notice of proposed levy. These notices explain how the taxpayer can request a collection due process hearing to protest the lien or levy and that the taxpayer can dispute the existence or amount of the underlying tax liability at the collection due process hearing if they did not already have a chance to dispute it and believe that collection is improper. (Code sections 6320 and 6331.) That would be the time for the taxpayer to raise the argument that they never received the notice of deficiency or notice of assessment.

If the taxpayer does not request a collection due process hearing and has not attempted to enter into a collection alternative with the IRS, such as an installment agreement or an Offer in Compromise, and their deficiency is more than \$50,000, the IRS can then certify the seriously delinquent tax debt to the Secretary of State and request a passport hold.

In this case, Taxpayer failed to file federal income tax returns for 2007 and 2009-2015. The IRS eventually proposed assessments for those years. Taxpayer claims that he never received any notices of deficiency or notices of assessment from the IRS and, therefore, could not have disputed the resulting assessments in Tax Court.

The IRS pursued collection action for these years. Taxpayer acknowledged receiving notices of liens and notification of his right to a collection due process hearing but admitted that he never requested a collection due process hearing to dispute the liens or the underlying liability.

The IRS also issued notices of intent to levy, informing Taxpayer about his right to a collection due process hearing. He admitted that he had never requested a collection due process hearing with respect to the levies either. After the levies were executed and complied with, Taxpayer still owed over \$1,000,000 on the underlying assessments.

In March 2020, the IRS certified the seriously delinquent tax debt to the State Department. Taxpayer filed a petition in Tax Court challenging the certification under section 7345. His certification challenge included five arguments: (1) that the IRS had never sent him notices of deficiency; (2) that the IRS had never sent him any notices that provided a due process opportunity to challenge the tax; (3) that the IRS never sent an explanation for the \$1.2 million deficiency; (4) that the IRS did not follow all legally required procedures to assess the tax; and in a very creative vein, (5) that the certification was an “unconstitutional taking away” of his right to travel.

The government successfully won a summary judgment motion at the Tax Court. The appeals court recently affirmed that Taxpayer was too late to challenge his underlying tax liability. The court noted that even if he could prove that the IRS had not properly sent him notices of deficiency, he previously had the opportunity to challenge that (and the underlying deficiency) in a collection due process hearing. By choosing not to avail himself of the opportunity when it was presented, he waived his chance.

It was not until his passport was in jeopardy that he woke up and tried to attack the validity of

the underlying tax liabilities. Code section 7345 does not give you a third bite at the apple and the court therefore affirmed the Tax Court's judgment.

Takeaway: The Internal Revenue Code provides a lot of protections for taxpayers, and the different notices that the IRS sends try to present these protections clearly. It is important to read the fine print in the notices to see what rights they provide because, at some point, you will no longer be able to dispute an underlying liability, no matter how good your facts are. Take the chance to fight while you can.

[Abouj](#) – don't underestimate the power of persuasion

In this case, Taxpayer was the sole shareholder of HPPO, an S corporation that owned several used car dealerships. It seems improbable that HPPO could ever have been a financial success; most of its customers had very poor credit, and historically, less than 10% ever paid their debt financing in full. HPPO repossessed approximately 25% of the cars within the first four months of purchase and approximately 50% of them within the first year.

HPPO, however, kept very detailed records, utilizing specialized accounting software designed specifically for car dealerships and maintaining dealer jackets on a car-by-car basis with all relevant paperwork relating to each sale.

The IRS audited both Taxpayer and HPPO in September 2015. The audit progressed very slowly, causing much frustration to the auditor. Taxpayer's long-time accountant was ill and subsequently died; the replacement power of attorney was not as well versed with HPPO's accounting methods and provided erroneous answers that confused the auditor. By the time the taxpayer finally retained a third person to represent him and HPPO, the auditor had given up and closed the case, issuing a notice of deficiency.

It appears that, frustrated with the lack of information, the auditor resorted to the bank deposit method to calculate HPPO's gross income and expenses. While she calculated that HPPO had over-reported gross income for 2013-2015 by more than \$3.25 million and underreported its gross income for 2016 by \$539,209, her Notice of Deficiency only assessed the additional income for 2016 and made no adjustments to the over-reported gross income for 2013-2015. This may have been one of the many reasons the judge ruled for Taxpayer in this case.

While the bank deposit method is an allowable method, it is most useful in determining gross income of cash basis taxpayers. But what the auditor didn't recognize (due to misinformation given to her by the second representative) was that HPPO reported its gross receipts on the accrual method. It included the entire sale price from a used car sale made on credit as gross receipts in the year of sale, even if only a small amount of the sales price was paid that year. The court found no evidence that HPPO had not properly reported its gross income under this accrual method, so it did not uphold the agent's determination of a gross income deficiency for 2016.

Several times throughout its opinion, the court noted that Taxpayer's testimony was very credible.

As discussed in this column numerous times, taxpayers may deduct ordinary and necessary expenses paid or incurred in carrying on a trade or business. [[Code section 162\(a\)](#).] The court again found the revenue agent's use of the bank deposit method to determine the proper amount of cost of goods sold and deductible business expenses to be incorrect as there was no way to determine that the items flagged by the auditor as "nondeductible" were actually deducted on HPPO's returns. Taxpayer provided additional documentation during the trial to substantiate the deducted expenses, and the court accepted them as reported on the returns.

The revenue agent had also disallowed a bad debt deduction, but the court found that Taxpayer's testimony about his inability to repossess approximately 250 cars was adequate substantiation for this deduction.

The revenue agent also found that Taxpayer had failed to report approximately \$7.5 million in distributions as income he received from HPPO. As the company was slowly wound up, Taxpayer admitted that he began taking money directly from the HPPO accounts to fund other business ventures as well as his personal expenses. While shareholder distributions from an S corporation can be taxable, neither party here argued that HPPO had accumulated earnings and profits, and thus, the only issue was whether or not Taxpayer had basis in his HPPO stock. See [Code section 1368](#). Distributions are not includible in gross income to the extent that they do not exceed the taxpayer's adjusted basis. [[Code section 1368\(b\) \(1\)](#).]

The revenue agent had not given Taxpayer credit for having any basis in the stock. The court found that the record, combined with Taxpayer's credible testimony, established sufficient evidence to reasonably estimate that he had a basis in his HPPO stock of \$5,090,383 at the start of the audit period. The distributions, therefore, were not taxable until they exceeded this basis. The court found this resulted in taxable distributions of \$642,605 in 2015 and \$1,919,967 in 2016.

The auditor also asserted accuracy-related penalties under [Code section 6662\(a\)](#) on the theory that there was a deficiency either due to negligence or a substantial understatement of income tax. We have often discussed, however, that there is a reasonable cause and good faith defense to the Code section 6662(a) penalties. [[Code section 6664\(c\)\(1\)](#).] Reasonable cause is determined on a case-by-case basis,

The court here continued to rely on Taxpayer's credible testimony and detailed record keeping to find that the underpayment in tax was not due to negligence and that he had acted with reasonable cause and in good faith. He had provided his accountant with all the records, including the bank statements showing the distributions he had taken from HPPO. Taxpayer testified that he did not know the tax impact of these distributions but that he relied on his accountant to treat them properly on the tax returns.

Takeaway: Do not give up. After the disastrous audit in this case, Taxpayer held firm and

succeeded at trial. He had the documents to support his testimony, and his confidence in his position persuaded the court to find in his favor on almost every issue.

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