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Tax Regs in Plain English

IRS Restructuring and Reform Act of 1998

3001 - Burden of Proof

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Section 3001

A. Provision(s) covered: Section 3001 (new I.R.C. § 7491). Burden of Proof.

B. Background: By statute or rule, the general burden of proof in court with respect to establishing the taxpayer's liability has always been placed upon the taxpayer. There were exceptions to this rule made by statute, court rule, and federal common law, but those exceptions were few. Under prior law, there was no specific burden of proof rules with respect to proof of income by statistic averages or with respect to penalties (except the fraud and other minor penalties); therefore, the taxpayer bore the burden of proof with respect to those issues also.

Congress believed that the placement of the general burden of proof on the taxpayers created the perception of "guilt until proven innocent" and that a better balance would place the burden of proof on the government to show an increase in liability if the taxpayer complied with the procedural and recordkeeping requirements of the tax laws. That is, if the taxpayer was generally law-abiding, it should be the government's responsibility to show that the taxpayer's determination of liability was not correct. Congress was also concerned that individual and small business taxpayers, who are generally tax compliant, are at a disadvantage when forced to litigate with the Service and the general burden of proof contributed to that unfairness or appearance of unfairness.

Congress also believed that it is inappropriate in all cases for the taxpayer to be required to disprove unreported income when the Service determined that income solely on statistical information on unrelated taxpayers. Finally, Congress was concerned that in a court proceeding, taxpayers often ignored the issue of penalties, and that they were applied by the courts and the IRS by “default.” Therefore, it determined that the IRS should not be able to rest on the presumption of correctness if it does not provide any evidence whatsoever relating to penalties.

C. Change(s): Three changes were made in the burden of proof in tax litigation.

1. A new provision places the general burden of proof on the Service with respect to factual issues in certain situations. To qualify, the taxpayer must show that they have complied with all the substantiation requirements; has maintained all the records required by the Code; has cooperated with all the Service's reasonable requests for witnesses, information, documents, meetings, and interviews; and meets certain net worth requirements.
2. A second provision places the burden of proof on the Service if it asserts an item of income based solely on statistical information relating to unrelated taxpayers. In this event, there is no requirement that the taxpayer maintain records or cooperate with the Service.
3. A third provision provides that when the Service asserts penalties, additions to tax, or additional amounts, the Service must initially produce evidence with respect to the penalty before the general burden of proof rules apply.

D. Impact

1. When taxpayers meet the prerequisites for a shift in the burden of proof, the Service will have the burden to show the correctness of the Service's position, rather than rely upon the taxpayer to “disprove” the Service's determination. However, this “shift” should not pose an unreasonable obstruction to the Service in determining the correct tax liability. Good auditing and good litigation practice, similar to most determinations in the past, will ordinarily produce sufficient evidence to sustain the burden of proof. That is, the Service and Chief Counsel have not, in the past, generally relied upon the taxpayer's failure of proof to sustain the asserted liability, but rather have affirmatively shown the proper liability. Adherence to these practices will satisfy the new standard, but it is now extremely important that a thorough investigation and documentation of liability be done prior to the initiation of litigation.
2. Further, the standard will now place greater emphasis and scrutiny as to the audit process. Under prior law, determinations of the court were strictly “de novo” meaning that what happened during the audit was immaterial -- the taxpayer needed to prove the proper liability in court. Now, the exceptions to the burden of proof rule concentrate on communications between the Service and the taxpayer during audit; that is, what requests for information were made by the Service and did the taxpayer cooperate. Thus it is essential that audit workpapers document the taxpayers cooperation and substantiation, and the Service's requests for information.

3. There is some concern that, despite the explicit requirements that the taxpayer substantiate items and cooperate with the Service, taxpayers may interpret the burden of proof standard as meaning that they no longer need to do these things. Service personnel thus should make the record maintenance and production requirements clear to taxpayers at all times.

E. Necessary Actions

1. Actions/Procedures: Revisions to the IRM and CCDM will need to be made to implement and explain this provision. Additional guidance and training as to the impact of these provisions will be necessary.
2. The public and Service personnel must understand that these new standards do not, in any way, detract from or minimize the responsibilities of taxpayers to properly determine, and document, their tax liabilities. Local outreach, and individualized discussions, will be necessary to continually underscore this point.

General Burden of Proof:

1. Things we CAN'T do: The Service can no longer rely on the taxpayer's failure to satisfy the burden of proof in court cases where the taxpayer has a reasonable factual dispute with the Service (provided the taxpayer has complied with the section 7491 requirements).
2. Things we CAN do: The Service can emphasize its examination procedures to further stress good auditing techniques. Evidence should be gathered and preserved from the earliest stage of a case, documenting whether the taxpayer has cooperated and the extent to which he or she did cooperate and produce information. All requirements of the law with respect to the treatment of an item for tax purposes should be explored and documented. Counsel can similarly emphasize good trial preparation and evidence production practice to satisfy the government's evidentiary burden.

Statistical Information:

1. Things we CAN'T do: The Service cannot rely solely on statistical information such as Bureau of Labor Statistics or Consumer Price Indexes to demonstrate unreported income. Additional investigation and documentation of unreported income is required. Note that this provision does not require direct evidence of income; however, the simple assertion that the taxpayer must have income equal to the average of the area's population will not be sufficient, without other evidence supporting that finding.
2. Things we CAN do: The Service can use statistical information and this should be sufficient to satisfy this provision and the general burden of proof, if, in addition to the statistical information, the Service can show evidence that the taxpayer's life style or expenditures of funds was consistent with the statistical information. There is no reason to abandon all usage of statistical information; rather a thorough examination will likely produce other circumstantial evidence that will support the income determination. In these instances, the use of statistical information will not be the sole means to

demonstrate income.

Penalties:

1. Things we CAN'T do: We cannot assert penalties arbitrarily and without a firm factual foundation.
2. Things we CAN do: Assert penalties when they objectively apply. Generally, workpapers should demonstrate the applicability of the penalties asserted. That is, if the return was delinquent or not filed, a printout of the module should be in the file attesting to the date filed or that no return was filed. The taxpayer should always be requested to submit an explanation of reasonable cause, if applicable for that penalty, and this response should be documented in the file. At trial, the Service should obtain a stipulation of the objective facts (e.g., late or nonfiling) or produce official Service records of that fact.

F. Other Special Comments: Additional guidelines and instructions will be provided. In the interim, Service personnel should use the guidelines above.

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