Office of Chief Counsel
Internal Revenue Service
memorandum

CC:PA:B03:POSTS-149170-07
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date: January 13, 2009

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subject: Verifying the Validity of Assessments in CDP Hearings When the Assessment is Based on a Notice of Deficiency

The Tax Court recently issued an opinion in Hoyle v. Commissioner that questioned whether the Appeals Office (Appeals) fulfilled its responsibility to verify that the Service followed all legal and administrative procedural requirements necessary for the administrative collection of the tax.[1] The court cited Butti v. Commissioner, another Collection Due Process (CDP) case issued earlier last year.[2] In these cases, Appeals issued notices of determination upholding assessments based on defaulted notices of deficiency. The taxpayers appealed and denied receiving the notices of deficiency. In Hoyle the court held that as part of the verification requirement under section 6330(c)(1), Appeals should verify whether a notice of deficiency was properly mailed before assessment, as required by section 6213(a). The court held that it will review this issue and other verification issues if raised by the taxpayer in Tax Court without regard to whether the taxpayer raised it at the CDP hearing. The court further held that if no notice of deficiency was mailed, the assessment is invalid and collection cannot proceed. Because the record was unclear, the court remanded to Appeals to clarify what evidence or records it relied on to determine the notice was properly sent to petitioner. Similarly, in Butti the court examined the adequacy of Appeals' verification. The court held that Appeals abused its discretion because there was insufficient verification the Service had mailed a notice of deficiency before making the assessment.

In light of the Hoyle and Butti cases, this memorandum addresses how Appeals should verify assessments based on defaulted notices of deficiency. Generally, Appeals may rely on tax transcripts to verify the validity of the assessments unless there is an irregularity. But where a taxpayer denies receiving the notice of deficiency, the taxpayer

[1] Hoyle v. Commissioner, 131 T.C. No. 13 (December 3, 2008).
[2] Butti v. Commissioner, T.C. Memo. 2008-82.

has alleged an irregularity and Appeals should not rely solely on transcripts to verify the validity of the assessments. Because verification issues such as the issuance or receipt of the notice of deficiency can be raised for the first time after taxpayers seek judicial review, we recommend Appeals ask taxpayers whether they received the notice of deficiency and document their responses. Finally, because problems with the proper assessment of penalties have been recurring in Tax Court cases involving nonfilers, this memorandum provides some background as to the legal prerequisites for penalties in such cases to assist your office in verification of the penalty assessments.

Verifying Assessments Made From Notices of Deficiency

By statute, Appeals has the independent duty to obtain verification of the validity of the assessments and to explain what records or evidence it relied on in fulfilling this duty. I.R.C. §§ 6330(c)(1) and (c)(3)(A); 6320(c). Because this is an independent duty, it applies in every CDP case. This includes cases where the assessment is based on either a filed return or a notice of deficiency. It includes liability cases, in which the taxpayer has raised liability, and nonliability cases, in which the taxpayer has failed to raise liability or is otherwise precluded from raising liability under section 6330(c)(2)(B). It also applies to cases for nonfilers who raise mostly frivolous arguments at the CDP hearing. Assessments against nonfilers must be preceded by a properly mailed notice of deficiency.[3] We, therefore, agree with the holding in Hoyle that taxpayers can raise verification issues, including issues relating to the issuance of the notice of deficiency, for the first time after they seek judicial review, without regard to whether they raised them at the CDP hearing.

Before we discuss what Appeals should and should not do for verification purposes in light of Hoyle, we briefly describe how the notice procedures work.[4] In all cases in which the assessment is based on a notice of deficiency, the Service's compliance with the notice procedures is critical to a valid assessment. The deficiency procedures are described in detail in regulations and in the Internal Revenue Manual. *See e.g.* Treas. Reg. §§ 301.6211-1, 301.6212-1, 301.6212-2, 301.6213-1; IRM 4.8.9; IRM 8.17.4. Generally, before assessing a deficiency in tax, the Service must send a notice of deficiency by certified or registered mail to the taxpayer's "last known address" and give the taxpayer the opportunity to petition and challenge the proposed deficiency in Tax Court. I.R.C. §§ 6213(a), 6212(a) and 6212(b)(1). Typically, the taxpayer's last known address is the address listed by the taxpayer on his or her most recently filed return

[3] We note that although we hope the number of frivolous cases will decrease with the implementation of section 6330(g), which permits the Service to disregard entirely frivolous hearing requests, we are seeing many new nonfiler cases raising only general or procedural objections without stating any grounds that can be clearly classified as frivolous. The claim that the taxpayer did not receive the statutory notices of deficiency upon which the assessments are based is on its face a nonfrivolous issue and should be addressed even if it is part of a seemingly frivolous hearing request.

[4] This memorandum discusses CDP cases only involving assessments based on a notice of deficiency. Of course, there are other assessments that may require Appeals to verify that the Service complied with preassessment procedures, for example, assessment of the trust fund recovery penalty in nonjeopardy situations. *See* I.R.C. § 6672(b) (preliminary notice requirement, effective for proposed assessments of trust fund recovery penalties made after June 30, 1996).

before the notice of deficiency was issued. If the Service did not send the notice to the taxpayer's last known address, the resulting assessment is invalid unless the taxpayer actually received the notice in time to file a timely Tax Court petition. A notice of deficiency consists of a letter determining the deficiency amount and a statement explaining how the deficiency was computed. If the taxpayer does not file a Tax Court petition (defaults) within the 90-day period (or 150-day period for taxpayers at overseas addresses), the Service may assess the deficiency in tax and any penalties asserted in the notice of deficiency without further notice.

As seen in cases such as Hoyle and Butti, the Tax Court has held that as part of verifying assessments based on notices of deficiency, Appeals must verify the proper issuance of the notices of deficiency. Generally, Tax Court cases have held that Appeals may rely on transcripts to verify the assessments were properly made unless there is an irregularity.[5] Thus, where the transcript shows the assessment was made pursuant to a defaulted statutory notice of deficiency, it would normally be presumed that the assessment was properly made. However, where the taxpayer denies receiving the notice of deficiency, the taxpayer has alleged an irregularity, and Appeals should not rely solely on the transcripts. For taxpayers who claim nonreceipt of the notice of deficiency including taxpayers making otherwise frivolous arguments, Appeals should go beyond transcripts and examine the underlying preassessment documents such as copies of the notices of deficiency and proof of mailing to verify the validity of assessments. Counsel has seen instances of appeals or settlement officers not doing so for taxpayers who told Appeals they did not receive the notice of deficiency.

We recognize that it would be impractical for Appeals to obtain copies of the notices of deficiency and proof of mailing in every case where the taxpayer has not raised the issue. We are not interpreting the court as requiring Appeals to conduct an in depth verification for taxpayers who do not raise the mailing or receipt issue, but rather for only those taxpayers who raise the issue before Appeals issues its notice of determination.

Appeals therefore should take the following steps. First, appeals or settlement officers should identify early in the case whether the assessments are based on a notice of deficiency. Second, if the assessments are based on a notice of deficiency, they should determine whether the taxpayers have raised the receipt or issuance issue.

If receipt is raised. Appeals should not solely rely on tax transcripts showing the making of an assessment in the case of taxpayers who deny receiving the notices of deficiency. In addition to reviewing the transcripts, the appeals or settlement officer should obtain and review the underlying documents that show the notice of deficiency was sent to the

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[5] *See, e.g.*, Cipolla v. Commissioner, T.C. Memo. 2004-6 (holding it is not an abuse of discretion for an appeals officer to rely on computer transcripts other than the Form 4340 for verification, unless the taxpayer can identify an irregularity in the assessment procedure or other procedures); Standifird v. Commissioner, T.C. Memo. 2002-245 (same); Craig v. Commissioner, 119 T.C. 252, 261-263 (2002) (Form 4340); Roberts v. Commissioner, 118 T.C. 365 (2002) (same); Nestor v. Commissioner, 118 T.C. 162 (2002) (same).

taxpayer's last known address by certified mail. This means at a minimum looking at copies of the notices of deficiency and certified mailing lists for the notices of deficiency.[6] A certified mail list is the best evidence that the deficiency notice was sent by certified mail. If the notice of deficiency did not assert the underlying tax or penalties, the assessment is invalid. If the Service did not send the notice of deficiency to the taxpayer's last known address, the resulting assessment is invalid unless the taxpayer actually received the notice in time to file a timely Tax Court petition. This does not necessarily mean that Appeals must determine that the assessment is invalid if all the relevant underlying documents cannot be obtained, because transcript entries showing issuance of the notice of deficiency,[7] recollections by IRS employees documented in the case activity record, and the results of web-initiated United States Postal Service searches, if available, might suffice. Counsel should be consulted if questions arise. In some nonfiler cases where proof of mailing the notice of deficiency is absent, it may be best to abate the assessment and reissue the notice of deficiency if the statute of limitations period is still open.

Where the taxpayer has filed a Tax Court petition in response to a notice of deficiency, and the court issues a decision and order determining the amount of tax due and any related penalties, it is not necessary to obtain the notice of deficiency and proof of mailing. Appeals may rely on the Tax Court decision to verify that the Service followed the preassessment deficiency procedures.

However Appeals determines that notices of deficiency were sent to the taxpayers, Appeals should document its efforts in making this determination in its case notes and explain in detail in its notices of determination how it arrived at this determination.

If issue is not raised. If the taxpayers inform Appeals verbally, or in correspondence, that they received the notice of deficiency, Appeals should put this acknowledgement in its case history notes and in the notice of determination as verification that the Service sent the notice. If taxpayers are silent on the receipt issue, we recommend that Appeals ask the taxpayers whether they received the notice of deficiency upon which the assessment is based. Asking the receipt question and documenting the response has several benefits. It might help Appeals verify the assessment as well as determine the separate issue of whether the taxpayer is precluded from raising liability during the CDP hearing. Also, under Hoyle there is always the risk if the receipt issue is not discussed at the CDP hearing, it may be raised in court and the case remanded if adequate documentation is not in the record. Asking the question up front may avoid remand.

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6 [redacted]

7 The problem is that transcript entries showing the actual issuance of the notice of deficiency and the date of issuance are rare.

Where the taxpayer does not raise the issuance or receipt issue, Appeals should still determine what the basis for the assessment is in every case, for example, whether the assessment is based on a notice of deficiency or on a filed return, and then explain what Appeals relied upon in making this determination. For example, if the taxpayer is a nonfiler and has not raised the issuance or receipt issue, Appeals could review the IDRS transcript and determine that the assessment was made after the Service prepared an SFR and a statutory notice of deficiency was defaulted upon, as indicated by the Action Codes (specify them) on the transcript. Boilerplate explanations that the appeals or settlement officer has verified that all procedures were followed or the notice of deficiency was mailed are inadequate.

Verifying Penalty Assessments for Nonfilers

Finally, we will summarize the legal prerequisites for penalties assessed in nonfiler cases after default of notices of deficiency. We have seen recurring problems in CDP cases where the failure to file penalty, failure to pay penalty, or both, may not have been properly included in the notice of deficiency, thus, calling into question the validity of the penalty assessments. Besides applying to deficiencies in the underlying tax, the notice of deficiency procedures also apply to additions to tax (penalties) asserted against nonfilers. For example, because the underlying tax constitutes a deficiency, the section 6651(a)(1) failure to file and section 6651(a)(2) failure to pay penalties, which are calculated on that tax, are attributable to a deficiency, and therefore subject to deficiency procedures as well. I.R.C. § 6665(b)(1).[8] Similarly, section 6665 makes deficiency procedures applicable to the failure to pay estimated tax penalty under section 6654 when no return is filed for a taxable year. I.R.C. § 6665(b)(2).

Accordingly, in addition to the deficiency in tax, the Service must include any of the above-mentioned penalties in a notice of deficiency sent to nonfiling taxpayers before the penalties are assessed. If the penalties are not included in a notice of deficiency, the penalty assessments would be invalid. Similar to the advice for the underlying tax set forth in this memorandum, Appeals must verify the penalty assessments and may rely on tax transcripts to do so unless there is an irregularity. If a nonfiler denies receiving the notice of deficiency, challenges the validity of the penalties based on the notice of deficiency, or raises both issues, Appeals should take the steps outlined in this memorandum to verify, determine, and explain how it determined that the Service followed the notice of deficiency procedures for the tax and penalty assessments.

Failure to File and Pay Penalties. In nonfiler cases it is common to see assessments of the failure to file penalty under section 6651(a)(1) (for late filers or nonfilers) and the failure to pay penalty under section 6651(a)(2) (for nonpayment or late payment).[9] *See*

[8] Note, deficiency procedures do not apply to the addition to tax (penalty) under section 6651(a)(3), but that penalty can be assessed only after a taxpayer fails to make timely payment in response to a notice and demand for payment. See footnote 9, *infra*.

[9] The section 6651(a)(2) penalty is applied to failures to pay the amount shown as tax on a return filed by a taxpayer or to pay the amount on a deemed return prepared by the Service under the section 6020(b) procedures (discussed later in this memorandum). The section 6651(a)(3) penalty relates to the failure to

also IRM 8.17.7.3; IRM 8.17.7.4; IRM 20.1.2. The following is a general description of the failure to file and failure to pay penalties.

If a return is not timely filed, section 6651(a)(1) generally provides for a penalty of 5 percent (increased to 15 percent for fraudulent failure to file under section 6651(f)) if the failure is for not more than one month, with an additional 5 percent for each month or fraction thereof during which the failure continues, but not in excess of 25 percent (increased to 75 percent for fraudulent failure to file). *See* IRM 20.1.2.1.2; IRM 20.1.2.7.

Under sections 6651(a)(2) and 6651(a)(3), the Service charges a late payment penalty of 0.5 percent of the tax owed for each month, or part of a month, the tax remains unpaid up to a maximum of 25 percent of the tax due. The 0.5 percent increases to 1 percent for each subsequent month if the tax remains unpaid 10 days after the IRS issues a notice of intent to levy. *See* I.R.C. § 6651(d)(2)(A). If both the failure to file penalty and the failure to pay penalty apply to any month, the failure to file penalty for that month (5 percent) is reduced by the failure to pay penalty for that month (0.5 percent). I.R.C. § 6651(c)(1). Section 6654(a) imposes a separate penalty for failure to pay, or for underpayment of, estimated taxes.

Substitute for Return. Generally, before the Service issues a notice of deficiency to a nonfiler, the Service will prepare a return under section 6020(b). A section 6020(b) return is not a substitute for a notice of deficiency. Even if the Service prepares a section 6020(b) return for a nonfiler, as discussed above, the Service is still required to issue a notice of deficiency before assessing the deficiency in tax and the failure to file, failure to pay, and estimated tax penalties. The 6020(b) procedures, however, are important for the purposes of the Service imposing a failure to pay penalty under section 6651(a)(2) against a nonfiler. Under section 6651(g)(2), a valid 6020(b) return is treated as the return filed by nonfiling taxpayers for purposes of determining the amount of a failure to pay penalty against them. A valid 6020(b) return is therefore a prerequisite to establishing a nonfiling taxpayer's liability for the failure to pay penalty under section 6651(a)(2).[10] A valid 6020(b) return, however, is not a prerequisite to the assertion of either a failure to file penalty under section 6651(a)(1) or a failure to pay estimated tax penalty under section 6654(a).

As such, if a nonfiler denies receiving the notice of deficiency and/or challenges the validity of the penalties based on the notice of deficiency, in addition to reviewing the notice of deficiency and proof of mailing, the appeals officer or settlement officer should also verify that the 6020(b) procedures were properly followed to justify an assessment of a section 6651(a)(2) failure to pay penalty. For further information on 6020(b)

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pay a deficiency that the Service has assessed and for which the Service has issued a notice and demand for payment. For notice and demands issued after December 31, 1996, the penalty is assessed if payment is not made within 21 calendar days from the date of a notice and demand (or 10 business days if the amount for which such notice and demand is made equals or exceeds $100,000).

[10] The failure to pay penalty on amounts shown on 6020(b) returns for returns due after July 30, 1996 (determined without regard to extensions) is calculated from the return due date under section 6651(a)(2).

procedures, see Temp. Treas. Reg. § 301.6020-1T, Chief Counsel Notice 2007-014 (June 18, 2007) (attached), and Chief Counsel Notice 2007-005 (February 4, 2007) (attached). The regulation provides that a document signed by an authorized officer or employee is a return under section 6020(b) if the document identifies the taxpayer by name and taxpayer identification number, contains sufficient information from which to compute the taxpayer's tax liability, and purports to be a return. A Form 13496, IRC Section 6020(b) Certification, or its automated counterpart, the IRC Section 6020(b) ASFR Certification, can be used to meet these requirements. Treas. Reg. § 301.6020-1T(b)(2). A Form 13496, an ASFR Certification, or any other form that an authorized officer or employee signs and uses to identify a document (or set of documents) as a section 6020(b) return is, along with the identified document(s), a valid section 6020(b) return if the combined material contains all of the necessary information.

Penalty mismatches. When verifying whether the Service properly included a penalty in the notice of deficiency for a nonfiler who denies receiving the notice of deficiency or challenges the penalty, the appeals officer or settlement officer should be wary of mismatches. For example, if the defaulted notice of deficiency determined a deficiency in tax and only a failure to pay penalty (6651(a)(2)), and the Service assessed the deficiency in tax and a failure to file penalty (6651(a)(1)) for the same year, the penalty assessment is invalid because the section 6651(a)(1) penalty was assessed without following the deficiency procedures. Not all discrepancies in how the penalty is listed on the notice of deficiency are necessarily fatal; consult Counsel if questions arise.

Conclusion

Due to the Tax Court's heightened concern about the adequacy of assessment verifications in CDP cases, we anticipate that Appeals will receive many more remands in cases docketed with the Tax Court, unless the issues raised in this memorandum are addressed in the notices of determination. We would be happy to work with your office to revise the current IRM provisions to better address these issues. Because of the importance of underlying documents to the collection and CDP process, we would also be glad to work with your office to see what can be done to ensure that exam files, notices of deficiency, and evidence of mailing are easy to locate and retrieve.

As we said, we are not requesting that Appeals do any more during the CDP hearing than rely on transcripts in cases where the taxpayer does not raise questions concerning the notice of deficiency and/or penalties.

Attachments: As stated (2)

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