Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Perry Castellani
(Chief, Governmental Liaison)

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from: Chief, Branch 7 /s/ Susan T. Mosley, Senior Technician Reviewer
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subject: Using State Tax Administration Audit Reports To Make Federal Tax Adjustments

This memorandum responds to your request for assistance, which is a follow-up to the advice on the use of state tax data for compliance purposes that we provided by memorandum dated July 17, 2006.

BACKGROUND

It is our understanding that, currently, some states provide state audit reports pertaining to individual, corporate, subchapter S, partnership, trust, employment, sales, and estate and gift taxes to the IRS in various formats. Both Small Business-Self Employed and Wage & Investment Campus Compliance Services utilize these reports to issue a federal audit report, if sufficient information is provided to indicate a source of unreported income.

[redacted] That said, it should be noted that the various states do not create a standardized audit report. Instead, a generic adjustment sheet containing an explanation is provided by the state examiner to the taxpayers. Only minimal information pertaining to the adjustments is input into the state's electronic system, which is the source of information sent electronically to IRS. Paper copies of state audit

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reports provide more detailed adjustment information and these reports could be obtained from the state, if needed for litigation purposes.

Thirty-seven of the forty-three states with an individual income tax start with Federal Adjusted Gross Income (FAGI) or Federal Taxable Income (FTXI) on their individual income tax return. Based on discussions with some states, compliance believes that all states that conduct audits could provide IRS with the state adjusted FAGI/FTXI or similar figures resulting from an audit.

At the conclusion of an audit, a majority of states do not have any formal agreement process, although a few states require the taxpayer to sign a document to agree to state findings. A fair number of states consider a case agreed if the taxpayer does not respond to the proposed assessment in the time allotted (usually 30-45 days) or if the taxpayer pays the assessment or makes payment arrangements. A case is considered unagreed if the taxpayer files a protest.

DISCUSSION[1]

Your office presented two questions for us to consider. Each question is premised on the fact that the source of the information is the state's adjusted data, not the return signed under penalty of perjury and filed with the state. The state data is final because the taxpayer either affirmatively agreed with the proposed adjustment or the agreement was by implication, *i.e.*, no timely protest was filed and the taxpayer began making payments or arranged to make payments. Thus, while the adjusted data is not a direct admission by the taxpayer, like when the signed state return is entered into evidence (except in the rare instances that the taxpayer has actually entered into a written agreement with the state as to the adjustment), it is reasonably reliable evidence of the amount of income.

We also note that both of your questions contain issues that involve determinations of policy, *i.e.*, whether the IRS should pursue certain actions. We are only providing advice as to the legal sufficiency of relying on state audit data to set the amount of income to determine the amount of federal tax deficiency. [redacted] DP

1. **If some states are unable to provide specific adjustment data, but can provide the state adjusted FAGI or FTXI, can a deficiency notice be issued based only on the state adjusted FAGI/FTXI? If yes, would there be any prohibition to using state business tax adjustment data to make federal assessments based on state tax adjustments to Forms 1120, 1120S, 1065, 1041, 941, etc.?**

[1] We had previously opined in our July 17, 2006, memorandum that there is no disclosure prohibition on the use of state tax data to make assessments of federal tax adjustments under either I.R.C. § 6103 or the Privacy Act of 1974, 5 U.S.C. 552a. We continue to hold this view for these instances as well.

As you are aware, the IRS cannot assess a tax deficiency without first issuing a notice of deficiency. With respect to non-filers, section 6020(b)(1) provides that when a person fails to make a return, the IRS is authorized to make a return based on whatever knowledge and information as is obtained "through testimony or *otherwise*." (Emphasis added.) This is a Substitute for Return (SFR). IRM 4.12.1.4.3.2(1)(b). In addition, subsection 6020(b)(2) provides that any "return so made and subscribed by the [IRS] shall be prima facie good and sufficient for all legal purposes."

If the taxpayer fails to keep records, or keeps incomplete records that neglect certain income, the IRS may compute income using whatever method the IRS believes accurately represents the correct amount of income. In field examinations, this often means a (possibly) lengthy audit of the taxpayer's books and third-party records, such as bank deposits or, for a business, third-party accounts payable to the business. The examination arrives at a reasonable evaluation of the taxpayer's income based on all the information available through the audit. Where the adjusted FAGI or FTXI is available from the state, the work to arrive at the adjusted income is done already by the state. You have indicated that you propose to use this information only when the taxpayer has agreed to the adjustments proposed by the state examiner, or has acquiesced to the determination by failing to file a protest. Under these circumstances, we believe it is reasonable to rely on the state data to make adjustments to the taxpayer's federal taxable income. The state's adjusted FAGI or FTXI is, in the words of section 6020(b)(1), "information ... obtain[ed] ... otherwise." Temporary Treasury Regulation 301.6020-1T(b) also provides that the IRS may "make the return by gathering information and making computations through electronic, automated or other means to make a determination of the taxpayer's liability." We believe the IRS's use of state supplied electronic records containing adjusted FAGI or FTXI data comports with Treas. Reg. 301.6020-1T(b)(1).

We note that while section 6020(b)(1) authorizes the IRS to file an SFR, it does not require it. *United States v. Verkuilen*, 690 F.2d 648, 657 (7th Cir. 1982). The IRS may issue a notice of deficiency without having to file a formal SFR for the taxpayer. *Tilley v. United States*, 270 F. Supp.2d 731, 737 (M.D. N.C. 2003); *Hartman v. Commissioner*, 65 T.C. 542, 546 (1975). Nonetheless, under section 7491(c), the Service has the burden of production for contested penalties and additions to tax. To meet this burden with respect to the section 6651(a)(2) addition to tax, the Service must offer as evidence the section 6020(b) return showing the unpaid tax as the basis on which the addition to tax is calculated. If the section 6020(b) return is not offered, respondent will not meet its burden of production, and the Tax Court will not sustain the addition to tax. *See, Wheeler v. Commissioner*, 127 T.C. 200 (2006); *Guthrie v. Commissioner*, T.C. Memo. 2006-81; and *Holmes v. Commissioner*, T.C. Memo. 2006-80. As noted in CC Notice 2007-005 (2/4/07) and CC Notice 2007-014 (6/18/07), the IRS should create an SFR or an Automated Substitute for Return before issuing a deficiency notice if the IRS wants to pursue certain penalties and additions to income.

With respect to underreporting, a deficiency exists the moment the taxpayer files a return understating his tax liability. Nonetheless, the IRS must determine the amount of

that deficiency. "By its very definition and etymology the word 'determination' irresistibly connotes consideration, resolution, conclusion, and judgment." *Scar v. Commissioner*, 814 F.2d 1363, 1368 (9th Cir. 1987)(citing *Appeal of Terminal Wine Co.*, 1 B.T.A. 697, 701 (1925)). In determining the amount of the deficiency, the IRS is to consider information pertaining to the particular taxpayer. *Scar* at 1368. "To qualify as a notice of deficiency, while a document need not assume any particular form ... nevertheless, it must meet certain substantial requirements. There must be a statement that the Internal Revenue Service has examined a return and determined a deficiency. It must inform the taxpayer of the exact amount of the deficiency." *Abrams v. Commissioner*, 787 F.2d 939, 941 (4th Cir. 1986)(internal citations omitted).

To prove a tax deficiency on the grounds of underreported income, the government must establish that the taxpayer had unreported income and that such income was taxable. *United States v. Conaway*, 11 F.3d 40, 43 (5th Cir. 1993). *See United States v. Chesson*, 933 F.2d 298, 306 (5th Cir. 1991). Proving taxable income often requires indirect methods of proof sufficiently reliable to overcome the doubts inherent in the use of circumstantial evidence. *See United States v. Boulet*, 577 F.2d 1165, 1167-68 & 1167 n. 3 (5th Cir.1978), *cert. denied*, 439 U.S. 1114 (1979).

The IRS intends to use information received from the states showing the adjusted state income tax return figures for FAGI or FTXI as the basis for determining a deficiency. These figures have either been agreed with or acquiesced to by the taxpayer. We believe the adjusted FAGI or FTXI would provide sufficient basis for determining a deficiency against the taxpayer, especially when the amount is supported by the state audit papers. It is reasonably reliable information pertaining to a particular taxpayer that provides the IRS with a basis to determine a deficiency and inform the taxpayer of the amount of the deficiency.

We have not found a legal prohibition against extending the use of state data to other processes, such as Form 1120, etc., but we would need to consider any special facts or circumstances arising in situations that are dissimilar to the standard deficiency notice procedures.

2. **Should underreporter assessment notices only use state adjusted FAGI/FTXI to be consistent when using states' data or should we use more detailed information if some states can provide more detail in an automated format? For example, if some states can only provide adjusted state FAGI or FXTI and other states can provide adjustments by detail, wages, interest, Sch. C, etc., does the proposed deficiency notice list the detail where provided or just the adjusted FAGI/FTXI?**

The IRS should use the most detailed state data available in forming its *basis* for determining a deficiency against a taxpayer in order to satisfy section 6212(a). Although there is no prescribed form for a deficiency notice, the notice must at a minimum indicate that the IRS has determined that a deficiency exists for a particular year and specify the amount of the deficiency. *Benzvi v. Commissioner*, 787 F.2d 1541,

1542 (11th Cir.1986). *See also Olsen v. Helvering*, 88 F.2d 650, 651 (2d Cir.1937) ("the notice is only to advise the person who is to pay the deficiency that the Commissioner means to assess him; anything that does this unequivocally is good enough."). In *Scar*, the court of appeals noted that it is "a long-established [Tax Court] policy not to look behind a deficiency notice to question the Commissioner's motives and *procedures* leading to a determination." *See Scar*, 814 F.2d at 1368 (emphasis added), and cases cited therein. But when the court can determine on the face of the notice that the IRS did not make a proper *determination*, the court may hold the notice to be invalid. *Id.* at 1368-1369.

> [t]he statute clearly contemplates that before notifying a taxpayer of a deficiency and hence before the Board can be concerned, a determination must be made by the Commissioner. This must mean a thoughtful and considered determination that the United States is entitled to an amount not yet paid. ...[more than] a mere formal demand for an arbitrary amount as to which there were substantial doubt....

814 F.2d at 1369, quoting *Couzens v. Commissioner*, 11 B.T.A. 1040, 1159 (1928).

We believe that the state adjusted FAGI or FTXI can be used to determine a deficiency and that the determination would not be arbitrary because the information on which the determination is founded relates to the specific taxpayer under audit. Accordingly, we believe that the IRS can use state adjusted FAGI and FTXI figures as a basis for determining a deficiency pursuant to section 6211.

LITIGATION HAZARDS AND OTHER CONSIDERATIONS

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Please call A M Gulas at (202) 622-4570 if you have any further questions.