

# Tax Court Reproach of “Cut-and-Paste” Notice Another Blow to IRS Documentation Credibility

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A Tax Court Memorandum Opinion expressing no confidence that a “slipshod-cut-and-paste” notice of deficiency was the version of the notice actually sent to the taxpayer is the latest in a string of rebukes from the Court and Congress questioning the IRS’s ability to retain credible and complete records. More concerning, recent cases call into question whether the IRS can be relied upon to truthfully represent the provenance of records it presents to support its position in disputes with taxpayers.

## **R.J. CHANNELS, INC. V. COMMISSIONER**

On August 28, 2023, the Tax Court served a Memorandum Opinion in the case of *R. J. Channels, Inc. v. Commissioner*, T.C. Memo. 2023-109, concluding that a Proposed Stipulated Decision should be stricken because the notice of deficiency (notice) that IRS counsel alleged was a “complete copy” and which was stamped “ORIGINAL” was, on the contrary, neither.

On September 29, 2021, the IRS filed its Answer with the Tax Court, attaching what IRS counsel alleged was a “complete copy” of the notice, which was stamped as “ORIGINAL” and contained a Continuation Sheet with an “Interest on Deficiencies” section and a “Civil Fraud Penalty IRC section 6663” section (Answer Notice).

The parties subsequently filed a Proposed Stipulation Decision, stipulating to an accuracy-related penalty under section 6662. The Court noted, however, that the record lacked any reference to the accuracy-related penalty and, as a result, struck the Proposed Stipulated Decision and ordered the parties to submit a revised version.

Pursuant to the Court’s Order, the parties filed a revised Proposed Stipulated Decision that was accompanied by a Status Report. This new Proposed Stipulated Decision included both a section 6663 civil fraud penalty and a section 6662 accuracy-related penalty. IRS counsel informed the Court in the Status Report that the section 6662 accuracy-related penalty was asserted as an alternative to the section 6663 civil fraud penalty, which is reflected on the “Continuation Sheet” and the “Civil Penalty Approval Form” that IRS counsel attached to the Status Report.

Also attached to the Status Report was another copy of the notice, but this notice was stamped as a “FILE COPY,” and the “Continuation Sheet” accompanying it had an “Interest on Deficiencies” section, a “Civil Fraud Penalty IRC section 6663” section, and an “Alternative Penalty Position” section (Status Report Notice). The Court observed that, compared to the “Alternative Penalty Position” section in the “Continuation Sheet” accompanying the Answer Notice,

the “Alternative Penalty Position” section was written in a different font size with different margins and was diagonal relative to the other sections.

When directed by the Court to explain these discrepancies, IRS counsel conceded that, at the time that the Answer was due to the Court, he did not have access to the case’s physical files because of COVID-19 restrictions. IRS counsel thus reconstructed the notice by combining the first page of an incomplete copy of the notice that the taxpayer had attached to its Petition with other records from an electronic database. IRS counsel represented to the Court that this was a “common practice,” but that certain sections of the notice were inadvertently excluded during the reconstruction process. When the Court inquired why it had not been informed of the discrepancies between the Answer Notice and the Status Report Notice, IRS counsel stated: “I was simply hoping that just by attaching a complete copy back with the Status Report it would at least put the correct notice on record.”

Dissatisfied with IRS counsel’s response, the Court stated that such conduct “falls woefully short of our expectations for practitioners who regularly appear before this Court.” Citing the importance of notices in the adjudicative and settlement processes, the Court noted that the “common practice” of reconstructing notices is “particularly disconcerting” and “created doubt as to whether respondent determined the accuracy-related penalty in the notice of deficiency sent to petitioner.”

Beyond the impact on this particular case, the findings of the Court are likely to give rise to more doubt as to the authenticity of documents that the IRS submits to the Court. Given IRS counsel’s admission that, at least at the onset of the COVID-19 pandemic, it was “common practice” to reconstruct notices when the actual documents were not available, notices issued during this period may be subject to additional scrutiny.

## **BACKDATED DOCUMENTS**

As previously discussed in Tax Impacts, the *R. J. Channels* decision was not the only recent blow to the IRS’s credibility. On August 29, 2023, the Tax Court served a Memorandum Opinion in the case of *Lakepoint Land II, LLC v. Commissioner*, T.C. Memo. 2023-111, concluding that IRS counsel in that case knew or should have known that his representations to the Court as to when a supervising revenue agent signed a penalty lead sheet were less than accurate, and that IRS counsel failed to timely advise the Court of the supervising revenue agent’s erroneous declaration regarding backdated documents. The Court agreed in principle that sanctions were appropriate and reserved ruling on specific sanction amounts until a later date.

The *Lakepoint* decision also raises the profile of three other cases in which IRS personnel are alleged to have intentionally backdated documents in order to impose maximum penalties on taxpayers. Such practices not only undermine the public’s trust in the IRS, but also raise ethical and legal concerns about the agency’s conduct.

## **DESTROYED INFORMATION RETURNS**

In addition to concerns regarding the completeness and authenticity of the IRS’s own records, the IRS has been subject to withering criticism of its treatment of taxpayer records. An April 4, 2022 report from the Treasury Inspector General for Tax Administration (TIGTA) revealed that the IRS had destroyed an estimated 30 million paper-filed information returns in March 2001. The document destruction, and particularly the non-disclosure of the purge, led to fierce criticism from both political parties in Congress. Republicans on the Senate Finance Committee said that the document destruction “raises questions about the IRS’[s] ability to administer the tax code and ensure compliance,” while the chair of the House Ways and Means Oversight Subcommittee went as far as to call for the then-Commissioner’s resignation.

Information returns include Forms 1042-S, *Foreign Person’s U.S. Source Income Subject to Withholding*; Forms 1098 series (including mortgage interest, student loan interest, and tuition payments); Forms 1099 series (including interest and dividend distributions); Forms 5498 series (including individual retirement arrangement and medical savings account information); Forms W-2, *Wage and Tax Statement*; Forms W-2G, *Certain Gambling Winnings*; and Schedules K-1 (partnership, S corporation, and estate or trust distributions). The IRS has explained that, after the end of the year, such information returns that remain in the backlog can no longer be processed due to technical limitations with the agency’s software. While the IRS at the time asserted that no taxpayers were penalized or will be penalized because of the document destruction, Tax Notes has recently reported that low-income taxpayers who

receive the Earned Income Tax Credit have been flagged by the IRS's automated auditing program and are subject to clawbacks of refunds because the IRS said the Forms 1099 for their non-employee income were missing. These incidents demonstrate how reliance on antiquated technology, and an abundance of paper filings, can result in unanticipated and unwelcome consequences to taxpayers.

## LOST MICROFILM RECORDS

On August 8, 2023, TIGTA released another report regarding the IRS's inadequate security measures, incomplete inventory records, and inability to account for thousands of missing microfilm cartridges. Again, the loss of taxpayer records—this time unintentionally—drew scrutiny from the halls of Congress. A letter signed by the House Ways and Means Committee Chair and the Senate Budget Committee Ranking Member dated August 24, 2023, decried the IRS's "lackadaisical attitude towards the loss of millions of taxpayer records" and demanded an accounting of the situation, including what steps are being taken to prevent the loss of records in the future.

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## Takeaways

The IRS's recent actions have cast a shadow over its credibility and integrity as a steward of taxpayer records and administrative files. From the destruction of vital tax documents to the mishandling of sensitive information and questionable practices in assessing penalties, the IRS is facing a crisis of trust. Rebuilding this trust will require a commitment to transparency, accountability, and a renewed dedication to the responsible handling of taxpayer information. Undoubtedly, many of these issues are also exacerbated by inadequate and antiquated technology that requires significant investment. In the absence of such measures, the IRS's credibility will continue to erode, with potentially far-reaching consequences for tax administration and compliance in the United States.

We will continue to monitor these developments. For more information or to discuss further, please contact the authors or your Winston relationship attorney.

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