Jackson v. Commissioner, 73 T. C. 394 (1979)

The IRS cannot rely on the presumption of correctness for a deficiency notice based solely on uncorroborated and unreliable informant information.

Summary

In Jackson v. Commissioner, the IRS determined that Leonard Jackson had unreported income from drug trafficking in 1970, relying solely on an informant's uncorroborated statements. The Tax Court held that the IRS's determination was arbitrary and excessive because it lacked substantive evidence, thus shifting the burden of proof to the IRS. The court found Jackson's testimony uncredible but noted the IRS failed to present any direct evidence linking Jackson to drug sales during the relevant period. This case underscores the necessity for the IRS to have a rational foundation for its deficiency notices and illustrates the limitations of relying on hearsay from unreliable sources.

Facts

Leonard Jackson was assessed a tax deficiency by the IRS for 1970, based on alleged income from heroin sales. The IRS's determination relied entirely on information from an informant who claimed to be part of Jackson's drug organization. The informant, arrested on drug charges, hoped for a lighter sentence by cooperating with authorities. However, he later jumped bail and refused to testify in Jackson's tax case. Jackson, a convicted drug dealer, denied any involvement in drug trafficking in 1970 and claimed his only income was from unemployment benefits.

Procedural History

The IRS issued a notice of deficiency to Jackson for unreported income from drug trafficking in 1970. Jackson petitioned the U. S. Tax Court, challenging the deficiency. The Tax Court found the IRS's determination to be arbitrary and excessive due to a lack of substantive evidence, shifting the burden of proof to the IRS. The court entered a decision under Rule 155.

Issue(s)

1. Whether the IRS's deficiency notice, based solely on information from an unreliable informant, can be presumed correct.
2. Whether the burden of proof shifts to the IRS when its determination is shown to be arbitrary and excessive.

Holding

1. No, because the IRS's determination was arbitrary and excessive, lacking a rational foundation in fact.
2. Yes, because once the IRS's determination is shown to be arbitrary, the burden

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shifts to the IRS to provide substantive evidence of the deficiency.

Court's Reasoning

The Tax Court emphasized that the usual presumption of correctness for IRS deficiency notices does not apply when the determination is shown to be arbitrary and excessive. The court applied the rule from Helvering v. Taylor, noting that the IRS's reliance on an informant with dubious credibility and no direct evidence of Jackson's drug activities in 1970 undermined the notice's validity. The court distinguished this case from Weimerskirch v. Commissioner, where the IRS provided some substantive evidence. The court also considered the informant's refusal to testify and his history of jumping bail as factors undermining his credibility. The majority opinion found that the IRS's method of projecting income was insufficient without a credible basis. Judge Irwin concurred, while Judge Quealy dissented, arguing that the IRS's actions were not arbitrary given the challenges in taxing income from illegal activities.

Practical Implications

This decision impacts how the IRS must substantiate deficiency notices, particularly in cases involving unreported income from illegal activities. It requires the IRS to have a rational foundation beyond hearsay from unreliable informants. Legal practitioners should advise clients to challenge deficiency notices lacking substantive evidence, as this can shift the burden of proof to the IRS. The case may influence future IRS investigations into income from illegal activities, encouraging the use of more direct evidence. Subsequent cases like Weimerskirch v. Commissioner have applied and distinguished this ruling, emphasizing the need for the IRS to support its determinations with credible evidence.

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