Shea v. Commissioner, 112 T. C. 183 (1999)

The Commissioner bears the burden of proof on new theories not described in the notice of deficiency if they require different evidence.

Summary

John D. Shea contested tax deficiencies determined by the IRS for 1990-1992, including disallowed business deductions and the application of California's community property law for 1992. The IRS conceded some deductions but argued that Shea was not entitled to community property benefits under IRC Sec. 66(b). The Tax Court held that the IRS's reliance on Sec. 66(b) was a new matter not described in the notice of deficiency, thus shifting the burden of proof to the IRS. The IRS failed to prove Sec. 66(b) applied, so Shea was entitled to community property benefits for 1992. The court upheld most of the IRS's adjustments to Shea's income and deductions for the years in question.

Facts

John D. Shea and his wife Flor filed joint returns for 1990 and 1991, and a delinquent joint return for 1992. Shea operated a consulting business, Shea Technology Group (STG), reporting income and deductions on Schedule C. The IRS determined deficiencies due to unreported STG receipts and disallowed deductions based on bank deposits and lack of substantiation. For 1992, the IRS changed Shea's filing status to married filing separately and determined his income without applying California's community property law. The IRS later relied on IRC Sec. 66(b) to deny Shea the benefits of community property law for 1992.

Procedural History

The IRS issued notices of deficiency for 1990-1992, which Shea contested in the U. S. Tax Court. The IRS conceded some deductions but maintained its position on the application of Sec. 66(b) for 1992. The case was tried by consent on the Sec. 66(b) issue, and the court reviewed the matter, resulting in a majority opinion.

Issue(s)

1. Whether Shea substantiated business deductions claimed on his 1990, 1991, and 1992 federal income tax returns.
2. Whether the IRS's reliance on IRC Sec. 66(b) to deny Shea the benefits of California's community property law for 1992 constitutes a new matter shifting the burden of proof to the IRS.
3. Whether the IRS met its burden of proof regarding the application of IRC Sec. 66(b) to Shea's 1992 income.

Holding

1. No, because Shea failed to substantiate most of the claimed deductions, except for telephone expenses in 1990 and 1991.
2. Yes, because the IRS's reliance on Sec. 66(b) was not described in the notice of deficiency and required different evidence, thus constituting new matter under Tax Court Rule 142(a).
3. No, because the IRS failed to prove that Shea acted as if he were solely entitled to the income and failed to notify his wife of its nature and amount before the return's due date.

Court's Reasoning

The court applied the legal rule that the taxpayer bears the burden of proof for deductions under IRC Sec. 162 and the substantiation requirements of Sec. 274(d). Shea failed to meet these standards for most deductions. Regarding the community property issue, the court held that the IRS's reliance on Sec. 66(b) was a new matter because it was not mentioned in the notice of deficiency and required different evidence than the issues described therein. The court rejected the IRS's argument that Sec. 66(b) was implicit in the notice, finding no evidence of its consideration when the notice was prepared. The court also interpreted IRC Sec. 7522, enacted after the Abatti decision, as requiring the IRS to describe the basis for a deficiency in the notice, supporting the court's traditional test for new matter. The IRS failed to meet its burden to prove Shea acted as if he were solely entitled to the income and failed to notify his wife, as required by Sec. 66(b).

Practical Implications

This decision clarifies that the IRS must describe the basis for a deficiency in the notice, or risk bearing the burden of proof on new theories requiring different evidence. Practitioners should ensure that notices of deficiency clearly articulate all bases for the deficiency to avoid shifting the burden of proof. Taxpayers in community property states should be aware that the IRS cannot deny community property benefits without proper notice and substantiation. The case also reinforces the strict substantiation requirements for business deductions, particularly those subject to Sec. 274(d). Subsequent cases have applied this ruling to require the IRS to provide adequate notice of its theories, influencing how deficiency cases are litigated in Tax Court.