Seawright v. Comm’r, 117 T. C. 294 (U. S. Tax Court 2001)

In Seawright v. Comm’r, the U. S. Tax Court ruled that IRC Section 7602(c), requiring advance notice of third-party contacts by the IRS, did not apply to pre-1999 examination activities or trial preparation. Additionally, the court held that Section 7602(e), limiting financial status audits, did not apply to actions taken before its effective date. The decision clarified the temporal scope of these IRS restrictions and affirmed the traditional burden of proof on taxpayers.

Parties

Samuel T. Seawright and Carol A. Seawright, Petitioners, v. Commissioner of Internal Revenue, Respondent.

Facts

Samuel T. Seawright operated Columbia North East Used Parts (Columbia), a salvage business in Columbia, South Carolina. In 1995, Columbia purchased 14 junked vehicles and automotive parts, spending a total of $18,742. During that year, Columbia rebuilt at least six damaged vehicles, which were sold in 1996 for $23,400. On their 1995 Federal income tax return, the Seawrights reported gross receipts of $20,852 for Columbia and claimed a cost of goods sold of $18,742. They also reported business expenses totaling $10,996, resulting in a net loss of $8,886.

The IRS, through agent Susan Leary, began examining the Seawrights’ 1995 return on July 16, 1998. During this examination, Leary asked routine background questions and requested sales records. The Seawrights informed Leary that the sales records were lost. On January 6, 2000, the IRS issued a notice of deficiency determining a $6,125 deficiency, disallowing $7,212 of claimed Schedule C expenses and the entire cost of goods sold. The Seawrights filed a petition with the U. S. Tax Court on February 15, 2000, challenging the deficiency notice and alleging violations of IRC Sections 7602(c) and 7602(e) by the IRS.

Procedural History

The IRS issued a notice of deficiency on January 6, 2000, asserting a $6,125 deficiency in the Seawrights’ 1995 Federal income tax. The Seawrights filed a timely petition with the U. S. Tax Court on February 15, 2000, contesting the deficiency and alleging that the IRS violated IRC Sections 7602(c) and 7602(e) during the examination and subsequent trial preparation. The IRS filed an answer on March 27, 2000, seeking affirmation of the deficiency. The case proceeded to trial on October 2, 2000, in Columbia, South Carolina. The Tax Court reviewed the case under the de novo standard of review.

Issue(s)

1. Whether IRC Section 7602(c), requiring the IRS to give taxpayers advance notice

of third-party contacts, applies to the IRS’s examination activities that occurred before the section’s effective date of January 19, 1999?

2. Whether IRC Section 7602(c) applies to the IRS’s trial preparation activities?

3. Whether IRC Section 7602(e), limiting the IRS’s use of financial status or economic reality examination techniques, applies to the IRS’s examination techniques employed before the section’s effective date of July 22, 1998?

4. Whether the Seawrights bear the burden of proof under IRC Section 7491?

5. Whether the Seawrights are entitled to deduct various business expenses of their salvage business in amounts greater than the IRS has allowed?

6. Whether the Seawrights are entitled to reduce gross receipts from their salvage business by certain amounts for cost of goods sold?

Rule(s) of Law

1. IRC Section 7602(c) requires the IRS to provide reasonable advance notice to taxpayers before contacting third parties regarding the determination or collection of tax liabilities. This section became effective for contacts made after January 18, 1999.

2. IRC Section 7602(e) restricts the IRS’s use of financial status or economic reality examination techniques unless there is a reasonable indication of unreported income. This section became effective on July 22, 1998.

3. IRC Section 7491 shifts the burden of proof to the IRS if certain conditions are met, including that the examination commenced after July 22, 1998.

4. IRC Section 162 allows deductions for ordinary and necessary business expenses.

5. IRC Section 61 and related regulations define gross income and cost of goods sold for businesses.

Holding

1. IRC Section 7602(c) does not apply to the IRS’s examination activities that occurred before its effective date of January 19, 1999.

2. IRC Section 7602(c) does not apply to the IRS’s trial preparation activities.

3. IRC Section 7602(e) does not apply to the IRS’s examination techniques employed before its effective date of July 22, 1998.

4. The Seawrights bear the burden of proof because the IRS’s examination commenced before July 23, 1998, and thus IRC Section 7491 does not apply.

5. The Seawrights are entitled to certain business expense deductions, but not in the amounts claimed. Specifically, they are entitled to deductions for insurance ($262), office expenses ($319), taxes and licenses ($1,105), and cat food ($300).

6. The Seawrights are not entitled to reduce gross receipts by the claimed cost of goods sold because they failed to establish the value of their opening and closing inventories.

Reasoning

The court reasoned that IRC Section 7602(c) was inapplicable to the IRS's examination activities before its effective date, as these activities occurred entirely before January 19, 1999. The court also found that the section did not apply to trial preparation activities, interpreting the statute's focus on examination and collection activities and relying on proposed regulations and legislative history.

Regarding IRC Section 7602(e), the court determined that the section did not apply to actions taken before its effective date of July 22, 1998. The Seawrights failed to show that the IRS violated the section after this date.

The court held that IRC Section 7491 did not shift the burden of proof to the IRS because the examination commenced before July 23, 1998. Thus, the Seawrights bore the traditional burden of proof.

On the business expenses issue, the court reviewed the Seawrights' claimed deductions and allowed certain expenses based on the evidence presented, but disallowed others due to lack of substantiation or misclassification.

Finally, the court rejected the Seawrights' claimed cost of goods sold because they failed to establish the value of their opening and closing inventories. The court calculated the cost of goods sold as zero, based on the Seawrights' zero-cost opening inventory and their failure to substantiate a lower market value for the ending inventory.

Disposition

The court entered a decision under Rule 155 for the respondent, affirming the IRS's determination of the deficiency.

Significance/Impact

Seawright v. Comm'r clarified the temporal scope of IRC Sections 7602(c) and 7602(e), reinforcing that these sections do not apply retroactively. The decision underscores the importance of taxpayers substantiating their business expenses and inventory valuations to support their tax positions. It also reaffirms the traditional allocation of the burden of proof to taxpayers in tax deficiency cases unless specific statutory conditions are met. The case serves as a reminder to practitioners and taxpayers about the necessity of timely and accurate record-keeping to support tax deductions and calculations.

