Deposition Rules

New Tax Court Rule May Change the Way the IRS Pursues Depositions

CPAs often find themselves representing individuals and businesses being audited by the IRS, as well as negotiating settlement of tax disputes in cases pending before the IRS Office of Appeals. Clients rely on their CPAs, even after a Tax Court petition is filed, to provide tax advice with respect to litigating positions being taken in Tax Court and their likely tax consequences. A new Tax Court Rule, however, may change the way certain cases are handled before the IRS.

The U.S. Tax Court amended its rules effective Jan. 1, 2010, to authorize the IRS—under certain circumstances—to obtain discovery by taking the deposition of a taxpayer *without consent*. This is one of the most significant changes to Tax Court practice in recent years and will likely impact the way CPAs represent taxpayers before the IRS.

Prior to the change CPAs rarely allowed a client to have any contact with the IRS to limit the scope of an IRS audit. Tax Court often was the first time that the IRS had an opportunity to cross-examine the taxpayer about the transaction at issue.

Former Tax Court Rule 74 allowed the IRS to take a taxpayer's deposition *so long as* the taxpayer consented to the deposition, which almost never occurred. Former Rules 74 and 75 provided for the taking of depositions without consent, but such depositions were limited to nonparty witnesses and expert witnesses. These depositions were considered an extraordinary method of discovery, required a court order and rarely occurred.

In light of the IRS' limited ability to take depositions, it has relied upon other discovery methods—requests for production of documents under Rule 72, written interrogatories under Rule 71 and cross-examination at trial—to prove its case.

New Tax Court Rule 74

New Tax Court Rule 74(c)(3) providing that a party may be deposed without consent was made to align the Tax Court's rules more closely to Rule 30 of the Federal Rules of Civil Procedure, which liberally permits deposition of parties. The new rule reflects the Court's growing acceptance of depositions as a trial preparation tool and activity that may enhance settlements in cases involving expert testimony. (Office of Chief Counsel Notice, Dec. 2, 2009, Amendments to U.S. Tax Court Rules of Practice and Procedure).

A new **Tax Court Rule** may change the way certain cases are handled before the IRS.

The Tax Court has, however, imposed limits on the IRS' ability to take a taxpayer's deposition.

As Rule 74(c)(1)(B) makes clear, the taking of a deposition of a party is an *extraordinary method* of discovery and may be used only where a party can give discoverable testimony that practically cannot be obtained through informal consultations or communication, interrogatories, request for production of documents or other discovery means.

Under Rule 74(c)(3), a party—such as the IRS—may take the deposition of another party without the consent of all the parties *if* the IRS files an appropriate motion pursuant to Rule 74(c)(3)(A), *and* the Court grants the motion after giving the nonmoving party or parties the opportunity to file a written objection or response thereto.

In the motion, the IRS must state the reason for taking the deposition, the substance of the expected testimony and an explanation of why the testimony is material to the case.

A judge should only order such a deposition "where the testimony or information sought practicably cannot be obtained through informal communications or the Court's normal discovery procedures and to extent consistent with Rule 70(b)(3)" (Explanation to Rule 74, the Tax Court's *Press Release dated Sept. 18, 2009* at 24.)

Applegate Case

The IRS has started to take taxpayers' depositions in light of the newly amended rules. In *Applegate v. Commissioner*, Docket No. 6127-08, Judge L. Paige Marvel issued an order June 11, 2010, granting an IRS motion to take the deposition of a party witness.

The IRS alleged that Brion and Patricia Appelgate ("petitioners") participated in a listed transaction and sought their deposition. The IRS alleged that Appelgate had relevant information, including the petitioners' motivation for engaging in the transaction, the transaction's purpose, the petitioners' investigation of the transaction and the execution of certain documents.

The IRS sought the petitioners' depositions to establish their understanding of the transaction, the subjective motivations for entering the transaction and the

> There are **successful strategies and tactics** that CPAs can execute to prevent—or manage the risk of—the IRS taking the taxpayer's deposition.

reasonableness of their purported reliance on professional tax advice.

In granting the IRS' motion, the Court reasoned that much of the information was "soft" information regarding the petitioners' intent and motivation in entering into the subject transaction, and that such information was difficult to capture by informal questions and formal interrogatories and often was not reflected or summarized in documents.

The Court pointed out that the petitioners had not consented to be interviewed on even an informal basis and that the IRS had received inconsistent and incomplete discovery responses.

The Court, however, imposed limitations on the deposition by ordering the IRS to designate the topics it intended to cover in the deposition and limited the deposition to no more than one day (seven hours).

The *Applegate* case stands for the proposition that the Tax Court likely will grant a motion for an order to take a deposition where the taxpayer's intent, state of mind or motivation is at issue in the case. These types of cases include:

1. Hobby loss cases where the taxpayer's profit motive is at issue;
2. Family limited partnership cases where the existence of a valid business purpose is at issue;
3. Innocent spouse cases whether the spouse knew or had reason to know of the alleged understatement of tax is at issue; and
4. Other cases where the taxpayer's credibility or intent is at issue.

In light of *Applegate*, CPAs should determine whether the case at hand is a "suspect" case so as to take steps early in the process toward managing the risk of having the taxpayer's deposition taken, as explained below.

Strategies to Avoid Deposition

There are successful strategies and tactics that CPAs can execute to prevent—or manage the risk of—the IRS taking the taxpayer's deposition, including:

- Cooperate to the extent possible in formal discovery and provide adequate responses to interrogatories and requests for production of documents.
- Do not allow the IRS to argue that the taxpayer provided inconsistent or incomplete discovery responses, as in the *Applegate* case.
- Build a strong case to show that the IRS already has the information it seeks through the documents and other discovery responses provided in the case.
- Consider agreeing to an interview that is limited in time and scope in exchange for an agreement with the IRS to not take the taxpayer's deposition.
- If the IRS files a motion to take a taxpayer's deposition, argue that the taxpayer has fully cooperated during discovery, provided adequate discovery responses and that the IRS has the information it seeks. Place the burden on the IRS to show why the deposition should proceed as an extraordinary method of discovery.
- Seek to obtain a court order limiting the length of the deposition and subject matter. Act proactively and not defensively.
- The IRS likely will limit the use of depositions to cases where the amount in dispute is substantial, such as a tax deficiency in excess of $1 million. Taxpayers who have filed petitions in small Tax Court cases where the amount in dispute is $50,000 or less are not likely to be deposed.

Deposition Preparation

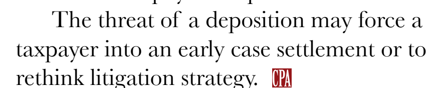
If the IRS prevails on its motion for an order to take a deposition, associate with an attorney, who can spend sufficient time preparing the taxpayer:

- Review key case documents, including interrogatory responses, during a mock Q&A session.
- Know and understand the IRS' theory of the case and anticipate IRS questions.
- Prepare the taxpayer for leading questions designed to elicit admissions.
- Review the deposition ground rules and evidentiary objections so the taxpayer knows what to expect.

Case Settlement at Appeals

The new rules likely will impact the settlement process with Appeals in cases where the IRS seeks to take a taxpayer's deposition. Expect Appeals to read relevant portions of the taxpayer's deposition transcript when assessing the hazards of litigation and formulating a settlement proposal. The deposition transcript may contain statements that are both helpful to the government and the taxpayer. In some cases, it may be best to conduct meaningful settlement talks before the IRS files a motion to take the taxpayer's deposition.

The threat of a deposition may force a taxpayer into an early case settlement or to rethink litigation strategy. CPA



Steven L. Walker, Esq. is a tax attorney and former IRS trial attorney. You can reach him at swalker@walk-law.com or www.walk-law.com.

want more?

New Era for Depositions

Read the text of the amendments on the Tax Court's website:
www.ustaxcourt.gov/rules/Title_VII.pdf

View a press release explaining the amendments:
www.ustaxcourt.gov/press/091809.pdf