

# TAX PROCEDURE: NAKED ASSESSMENTS, NEW MATTER, AND THE BURDEN OF PROOF, A PROCEDURAL GRAB BAG

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The burden of proof is important in any litigation. While this is equally true in tax cases, there are some special rules that apply. For example, a tax assessment issued by the IRS is subject to a presumption of correctness, leaving the taxpayer to establish, by a preponderance of the evidence, that the assessment is incorrect. See *Helvering v Taylor*, 293 U.S. 507, 515 (1935). But that presumption may not apply if the assessment is “naked” and lacks any foundation. See *United States v. Janis*, 428 U.S. 433, 441-42 (1976). In a similar vein, while the burden of proof is generally on the taxpayer, if the IRS asserts new matter in its answer, the government will bear the burden of proof. Tax Ct. R. Prac. & Proc. 142(a)(1). While that sounds clear, in a particular case, what constitutes “new matter” can be subject to debate.

Last week, the First Circuit issued an opinion addressing both naked assessments and new matter; it also clarified the nature of a taxpayer’s burden of proof on the merits. *Cavallaro v. Comm’r*, No. 15-1368; 13-1376, 2016 U.S. App. LEXIS 20713 (1st Cir. Nov. 18, 2016).

*Cavallaro* was a gift tax case; the taxpayers, William and Patricia Cavallaro, owned Knight Tool Co., a tool manufacturer. 2016 U.S. App. LEXIS 20713 at \*1-\*2. The taxpayers’ three sons all worked at Knight. In 1982, Knight created a dispensing system for liquid adhesives known as “CAM/ALOT,” but the project was abandoned due to costs and development problems. *Id.* at \*2. One of the taxpayers’ children asked if he could continue to work on developing the technology in conjunction with his brothers, and the taxpayers agreed. The brothers formed a new corporation, Camelot, and they worked on changes to the product’s design to meet customer requirements; a variety of Knight personnel worked on the project, including William Cavallaro. *Id.*

The relationship between Knight and the new corporation, Camelot, was not at arms’ length: Everyone who worked at Camelot on the dispensing system continued on Knight’s payroll, and Camelot’s bills were generally paid by Knight. *Id.* at \*2-\*3. Knight manufactured the dispensing system, which Camelot sold to third parties. *Id.* at \*2.

Several years later, the taxpayers reviewed their estate plan, receiving competing advice from their lawyers and their accountants concerning the treatment of the relevant technology: The accountants thought that the evidence showed that the relevant technology was owned by Knight, while the attorneys

argued that the technology had been transferred to Camelot and was therefore already owned by the taxpayers' three sons. *Id.* at \*3. While the lawyers prevailed in the debate, the process left behind an unfortunate letter in which one lawyer commented that he would have to "squeeze a few embarrassing facts into the suitcase by force" to sustain the position that Camelot, the sons' corporation, owned the technology. *Id.* at \*4.

Knight and Camelot then prepared to merge; an accountant valued the two corporations, opining that the combined entity was worth between \$70-\$75 million and that Knight's value was only nineteen percent of the combined total. The valuation rested on two critical assumptions: that Camelot owned the relevant technology, and that Knight was a contractor. *Id.* at \*4.

After the merger, Camelot was the survivor, and the taxpayers owned a minority stake in it. Their three sons, the former Camelot shareholders, owned the majority. This allocation of shares was driven by the valuation prepared in advance of the merger. *Id.* at \*4-\*5. The combined company then was sold for cash several months later. *Id.* at \*5.

In the course of a normal audit, the IRS noted the possibility of a gift tax issue and opened a separate gift tax examination. *Id.* In that examination, the IRS did not obtain an appraisal; it simply issued a notice of deficiency that was premised on the assumption that Camelot's value at the time of the merger was zero dollars. The deficiency in gift tax was \$12,696,750. *Id.* at \*5-\*6.

The taxpayers filed petition for review with the Tax Court. During discovery, the government revealed that it had retained an accountant to conduct an appraisal of both Knight and Camelot prior to the merger; this valuation put the overall value of the combined companies at \$64.5 million and set the value of Camelot at \$22.6. *Id.* at \*6.

In light of the apparent change in the government's position, the taxpayers sought to shift the burden of proof to the IRS at trial, arguing that the new appraisal demonstrated that the assessment was arbitrary and not subject to the normal presumption of correctness. They also argued that the valuation triggered a shift in the burden of proof through the assertion of new matter because the government was proceeding on a theory that had not been the basis for the deficiency assessment. [The Tax Court disagreed.](#) *Id.* at \*7.

On appeal, the First Circuit began with the standard for determining that an assessment is a "naked assessment," one which is excessive and arbitrary. To meet this standard, the court indicated that the taxpayers had to demonstrate that the deficiency assessment had "no factual relationship to the [Cavallaro's] liability," a standard that could not be met through "a challenge to any proof offered by the Commissioner at trial." *Id.* at \*10 (quoting *Zunone v. Comm'r*, 883 F.2d 1317, 1325 (7th Cir. 1989)). While the taxpayers pointed to the government's shift from an assumption that Camelot had zero value to a valuation that gave it substantial value, in the First Circuit's view that this was not sufficient; the Court reasoned that the change in the government's position represented nothing more than a partial concession. *Id.* at \*11-\*12 (citing *Silverman v. Comm'r*, 538 F.2d 927, 931 (2d Cir. 1976); *McMurty v. Comm'r*, 203 F.2d 659, 665-666 (1st Cir. 1953)). In the court's view, the lawyer's letter discussing "embarrassing facts" and other related documents gave the IRS a sufficient basis to conclude the value of Camelot at the time of the merger was minimal. *Id.* at \*12.

The taxpayers' contention that the burden should be shifted because the IRS had raised "new matter" was equally unavailing. While the Cavallaros argued that the IRS had backed away from a theory that Camelot was a complete sham, the language of the deficiency notice indicated that there were taxable gifts because Knight was undervalued. As a consequence, the First Circuit held that the government's

shift from its original position that Camelot had no value to its subsequent valuation that assigned it \$22.6 million in value represented “a clarification of the extent to which Knight was undervalued.” *Id.* at \*15.

While the taxpayers’ efforts to shift the burden of proof to the IRS were not successful, they did prevail on a third issue concerning the burden of proof: The taxpayers had attacked the valuation offered by the IRS, but the Tax Court refused to consider the evidence that they offered, reasoning that the taxpayers were required to show the true extent of their tax liability. *Id.* \*22-\*23. In contrast, the Cavallaros argued that they merely had to show that the deficiencies assessed by the IRS were incorrect.

The problem arose because the taxpayers’ valuation witnesses had assumed that Camelot, the new corporation, had owned the technology. Those opinions were undercut by the Tax Court’s determination that it was Knight that actually owned the technology. *Id.* at \*23-\*24. As a consequence, the Tax Court simply adopted the valuation evidence offered by the government. The First Circuit concluded that the court had misapprehended the taxpayers’ burden of proof, which only requires a taxpayer to show that the assessment was excessive; once that burden was met, “the taxpayer cannot be made to pay the amount assessed against him—even if he fails to prove the correct amount of liability he owes.” *Id.* at \*24 (citing *Helvering v Taylor*, 293 U.S. at 515; *United States v. Rexach*, 482 F.2d 10, 16 n. 3 (1st Cir. 1973)).

The First Circuit ruled that the Tax Court’s refusal to consider the taxpayers’ challenge to the government’s valuation evidence was an error: The Court held that the Tax Court should have considered the alleged flaws in that evidence and “determined for itself the correct amount of tax liability, rather than simply adopting the Commissioner’s position.” *Id.* at \*26.



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