Tax Court Pleading Standard Suffers From Lack of Clarity

by Andrew Velarde

A procedural issue on the minds of several tax experts involves Tax Court pleadings and the standard for ruling on motions to dismiss for failure to state a claim — a standard that has changed in recent years but whose applicability in the tax context remains ambiguous.

The issue has been somewhat under the radar, despite its change in treatment in federal court following two Supreme Court decisions. Sixty years ago, in *Conley v. Gibson*, 355 U.S. 41 (1957), the Supreme Court held that black railroad employees adequately set forth a claim for relief in a class action suit against their union. The Court deemed it improper to dismiss a complaint for a failure to state a claim "unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief."

"We have no doubt that petitioners' complaint adequately set forth a claim and gave the respondents fair notice of its basis," Justice Hugo Black wrote. "The Federal Rules reject the approach that pleading is a game of skill in which one misstep by counsel may be decisive to the outcome, and accept the principle that the purpose of pleading is to facilitate a proper decision on the merits."

Half a century later, the Supreme Court again decided on pleading standards, in *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007). Justice David Souter, writing for the Court, held that a pleading in an antitrust conspiracy case failed to plead enough facts to establish plausible grounds for relief and rejected *Conley*'s "no set of facts" language.

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"To be fair to the *Conley* Court, the passage should be understood in light of the opinion's preceding summary of the complaint's concrete allegations, which the Court quite reasonably understood as amply stating a claim for relief," Souter wrote. "But the passage so often quoted fails to mention this understanding on the part of the Court, and after puzzling the profession for 50 years, this famous observation has earned its retirement."

Two years later, in *Ashcroft v. Iqbal*, 56 U.S. 662 (2009), the Court again decided on the adequacy of a complaint, this time in a discrimination case brought by a Muslim man who had been detained by authorities. It held that the plausibility standard from *Twombly* applied beyond antitrust cases.

Describing the recent case law's application in various jurisdictions, Carlton Smith, former director of the Cardozo School of Law Tax Clinic, said he's not sure the Tax Court judges are even aware of the pleading issue in their court, "but every single district court judge is aware of *Twombly* and *Iqbal*." He added, "The Tax Court judges are still effectively applying *Conley v. Gibson* or even something looser than that."

Smith said he was concerned that the Tax Court might adopt the *Twombly/Iqbal* standard as precedent without giving the issue proper consideration. "Some judge is going to write an opinion where he or she cites *Twombly* and may not realize what he or she has just done," he said.

A Dearth of Citations

Although *Conley*'s application on motions to dismiss for failure to state a claim was cited in a memorandum opinion in 2003, *Conley*, *Twombly*, and *Iqbal* don't appear to be cited in any authoritative manner in Tax Court decisions since the latter two Supreme Court decisions were issued. A search of the Tax Court's database for orders going back to June 2011 shows that *Twombly* has been cited three times by the court, including June 1 of this year, on a motion to dismiss for failure to state a claim, though not for the proposition that its standard abrogated *Conley*. In 2013 an order in a whistleblower case cited *Twombly*, finding dismissal appropriate when it was undisputed that the IRS collected proceeds based on information provided by the petitioner.

By contrast, Tax Court orders have cited *Conley* eight times, including as recently as June 13, when the court justified granting a motion to dismiss under Rule 40 in cases when it is beyond

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a doubt that the other party has "no set of facts in support of a claim" that could grant relief. Of course, orders are not precedential and thus do not answer the question of which standard controls.

Concerns over a changing standard may be even more pressing now, given a recent IRS motion to dismiss for failure to state a claim in a whistleblower case. In its filing in *Spencer v. Commissioner*, 8760-17W, the IRS argued that Garth Spencer failed to allege judicial or administrative action based on his information or that the IRS collected proceeds based on the information. Spencer submitted a whistleblower claim alleging that a taxpayer owed $7.3 million in tax and penalties, but the IRS succinctly denied the claim, a decision on which Spencer now seeks discovery. The motion states that "a petition must contain allegations respecting all the material elements necessary to sustain recovery," and to withstand a motion to dismiss for failure to state a claim, the "petitioner must plead factual allegations sufficient to raise a right to relief above the speculative level." It cites *Twombly* as abrogating *Conley*'s plaintiff deferential standard, as well as *Iqbal* generally.

In his opposition to the motion to dismiss, Spencer argued that a lack of IRS action and collected proceeds should be raised as affirmative defenses and do not constitute requirements of pleading. In the alternative, Spencer argued that the Tax Court should apply the traditional notice pleading standard of *Conley*, which he asserts his pleading meets. He argued that it is "not entirely clear" what the requirements are for a whistleblower petition to survive a motion to dismiss.

> ***Spencer argued that a lack of IRS action and collected proceeds should be raised as affirmative defenses and do not constitute requirements of pleading.***

"If the Court were to adopt the pleading requirements proposed in the Motion, then many (if not most) whistleblowers with denied claims would be effectively precluded from obtaining judicial review. This result would run counter to clear Congressional intent," the filing argues, adding that a whistleblower is unlikely to know whether the IRS proceeded with an action when a claim is denied if there is no ongoing relationship with the taxpayer. "He cannot know how the IRS is interpreting the whistleblower law, and cannot verify the IRS's conclusory rationale for denying the claim," the filing says. The opposition brief cites *Cooper v. Commissioner*, 136 T.C. No. 30 (2011), for the proposition that evidence on IRS action and collected proceeds "is properly considered on the more developed factual record" in summary judgment.

Steve R. Johnson of Florida State University College of Law sees in camera review by the Tax Court as one potential solution in *Spencer*. He compared that with levy proceedings against a taxpayer's house, which requires judicial approval, or discovery requests of privileged information, either of which might serve as a model. That procedure would avoid section 6103 issues, but it would still likely require a statutory amendment, a much more cumbersome process, he said.

"Fundamentally, what we are dealing with here is, on the one hand, it seems fair and reasonable that the whistleblower should be given access to information that allows them to figure out if they got a claim, versus . . . the privacy concerns that are implicated under 6103. This kind of approach would be a way of balancing those competing considerations," Johnson said.

In its motion to dismiss for failure to state a claim, the IRS asserted that it took no action based on the information provided by the petitioner. Parsing that language, Johnson interpreted it as meaning one of two things: Either no action was taken at all, or action was taken based on something else. The second possibility is much more of a concern in need of judicial remedy, Johnson argued, because it was less straightforward and a matter of interpretation.

Spencer's brief also cites the IRS's "conclusory assertion" possibly arising from mistaken facts, as was the case in *Gonzalez v. Commissioner*, T.C. Memo. 2017-105, or resulting from "considerable ambiguity surrounding definition of key terms, about which the IRS and whistleblowers may reasonably disagree," such as "administrative action" or "proceeds based on."

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'Shooting Fish in a Barrel'

While pro se litigants whose pleadings may lack legal sophistication could be some of the most affected parties if *Twombly/Iqbal* were adopted by the Tax Court, Smith said he doesn't expect the IRS to initially make motions to dismiss for failure to state a claim against deficiency, innocent spouse, and collection due process petitions "that usually contain only a few sentences barely making it clear what is disputed."

"The IRS shooting at these petitions under *Twombly/Iqbal* would be shooting fish in a barrel," Smith said. He added that while it is difficult to quantify how much tougher a plausibility standard is compared with a notice standard, it is inarguably tougher for a petitioner to meet the former, in some as-of-yet undefined way.

Smith argued that a *Twombly/Iqbal* standard could allow the IRS to make motions to dismiss for failure to state a claim against "people it didn't like," such as tax protesters, and in cases when it may be "on shaky legal ground," which could lead to many more petitions being dismissed than are currently. For example, he wondered whether under the plausibility standard, an innocent spouse relief pleading would need to plead facts relating to all seven equitable factors elaborated in section 4.03(2) of Rev. Proc. 2013-34, 2013-43 IRB 397, to avoid dismissal.

"*Twombly/Iqbal* would end up a tool for the IRS to abuse its discretion, since I don't think the IRS would still want to use it in the vast majority of cases," Smith said; otherwise, it would "risk pushback from the Tax Court."

In a September 2015 letter to the Tax Court asking it to clarify its standard on motions to dismiss for failure to state a claim, Smith advanced several arguments why the *Conley* standard should be maintained, in addition to most lawsuits being filed by pro se litigants. He argued that the plausibility standard would be difficult to apply in the Tax Court; that the IRS can control its workload because most cases spring from IRS-issued notices; and that there is a lack of discovery issues of concern in *Twombly* and *Iqbal*, as well as a lack of nuisance suits and settlements.

Narrow or Broad

Smith did not predict different pleading standards based on which jurisdiction is involved.

The Tax Court "now has about 20 jurisdictions, and it still maintains, at least nominally, the same pleading rules" for all of them, Smith said.

Smith argued that even if the Tax Court were to change the whistleblower pleading rules to require more factual allegations, he didn't foresee the court going so far as to apply *Twombly/Iqbal* in any such rule-specific change. He said that "information asymmetry" made the pleading standard issue particularly important to whistleblowers.

"In most cases, who cares what happens administratively? It is not important because the Tax Court [reviews] *de novo*. But in whistleblower cases, a lot of what happened on the IRS side is critical to you getting a recovery. And who knows what went on on the IRS side?" Smith asked. He noted that Tax Court Rule 33, requiring good faith in pleadings upon signature, could prevent a whistleblower from alleging facts such as whether the IRS took action or collected proceeds based on petitioner information. "How is he going to certify the truth if he puts in something he has no idea is true or not?"

Johnson, however, did not think the Tax Court needed to abide by the *Conley* standard for all taxpayers. While he acknowledged Smith's argument about the plethora of pro se litigants, he was not troubled by that because most of their pleadings would not be deficient, even under *Twombly*. Further, those deficient could be salvaged through the existing Tax Court practice of issuing an order for the petitioner to file an amended pleading, he argued.

"Once the Tax Court issues such an order, if the pro se taxpayer really has a case, fine. Set it out," Johnson said. "At that point, the ignorance problem is gone. They now know they have to allege specifics, and since the pro se taxpayers in the overwhelming majority of cases were the parties to the transaction, they should know the facts well enough to say something that works," he said, adding that courts typically "bend over backward to accommodate the pro se and interpret the pleading generously."

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But Johnson argued that while there may not be a need generally to apply the lower pleading standard, a special rule should apply when involving petitioners who were not parties to the transaction, which would include whistleblowers as well as cases involving transferee liability, such as might occur with fraudulent conveyance. In both cases, it is possible that the petitioner would not be privy to all relevant facts. He said that liability under section 6672, not often tried in Tax Court, is another example that may require a lower standard.

> ***Johnson argued that a special rule should apply when involving petitioners who were not parties to the transaction, which would include whistleblowers as well as cases involving transferee liability.***

"Whistleblowers are a good example of . . . situations in which the petitioner/plaintiff in the Tax Court is somebody who is not a party to the transaction. And in the transferee liability context we have recognized that fact," Johnson said, citing section 6902(b), which gives the transferee a special discovery procedure involving the preliminary examination of documents of the taxpayer.

Recently, in *Lippolis v. Commissioner*, T.C. Memo. 2017-104, and *Gonzalez*, released on the same day and applying the same analysis, the Tax Court denied IRS motions for summary judgment against whistleblowers because the facts alleged in the motions didn't preclude the existence of other records showing that amounts in dispute exceeded the necessary threshold. Smith drew comparisons between those cases and the information gap that could exist in whistleblower pleadings.

"The court in *Gonzalez* and *Lippolis* noted that the petitioners should be allowed to demand more by way of proof for this fact than merely the IRS's unsworn statement, since the IRS had all the information — unlike the usual deficiency case, where the taxpayer has most or all of the information," Smith said.

Spirit of *Twombly/Iqbal*

Under Tax Court Rule 341 involving commencement of a whistleblower action, a petition is required to have a date of determination regarding an award, lettered statements explaining why the petitioner disagrees with the IRS Whistleblower Office determination and setting forth facts on which they rely to support their position, and a prayer for relief. More generally, Rule 31 requires that pleadings "be simple, concise, and direct" and that their purpose is to give parties "fair notice of the matters in controversy" — language that would seem to mimic *Conley*, although it's worth noting that fair notice was part of the Tax Court rule before *Twombly/Iqbal*. Rule 1(b) states that when there is no applicable rule, the court will give weight to the Federal Rules of Civil Procedure, if they are "suitably adaptable."

"It's clear that *Twombly* and *Iqbal* govern under the Federal Rules of Civil Procedure uniformly without differentiation based on the kind of case," Johnson said, but he thought Tax Court Rule 1(b) would not preclude Spencer's position. He foresaw Rule 1(b) presenting a larger problem to a broad application of *Conley* than to a narrow application advanced by Spencer, because Spencer could argue that the Federal Rules of Civil Procedure are not suitably adaptable to situations in which petitioners did not have firsthand knowledge of all facts.

Rule 34(b)(5), however, presented a greater obstacle for Spencer because that rule requires petitions to have "clear and concise lettered statements of the facts," Johnson said. While the rule didn't apply literally because it applied to deficiency actions, since the Tax Court's principal jurisdiction was over those types of actions, "much of the Tax Court culture was based around" it. Rule 341 has similar language related to facts, though it omits "clear and concise." In its motion to dismiss, the IRS cites Rule 341, as well as Rule 31. Johnson argued that while the language of Rule 341 favored the government, there was still room for interpretation.

"Put yourself in the position of the Tax Court judge who is deciding this," Johnson said. "There is a huge difference in the nature of the [written positions]. The government's . . . is short, basically saying, 'There was *Conley*, but now the Supreme Court has said it is *Twombly/Iqbal* and it applies here. End of discussion.' Nothing about policy.

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Nothing about is it fair or is it reasonable in this context.

"It's basically precedential: '*Twombly* controls; get lost, Spencer.' And Spencer's responsive pleading is much longer. It goes into policy," Johnson continued. How the case is decided may depend on the proclivities of the judges and how bold they wanted to be in deciding whether they wanted to address "the creakiness in the rules," he said.

"If you take [*Twombly*/*Iqbal*] literally . . . the government [wins]. But if you take them in terms of their spirit, you can turn them around in favor of Spencer," Johnson said. *Twombly* and *Iqbal* could be seen to stand for the proposition that the judicial system should address real problems affecting litigants arising from the pleading standards. "If that was the motivating spirit behind *Twombly* and *Iqbal,* that is exactly what Spencer is asking for," he said. ■

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