International Review of Business Research Papers
Vol. 7. No. 1. January 2011. Pp. 231 – 238

Taxpayers' in Australia Bear the Burden of Persuasion and Burden of Production.

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In Australia taxpayers bear the burden of proof, both of persuasion and of production. The rationales for this are many and varied. Legislation in the U.S. has sought to lessen the taxpayers' burden of persuasion and has resulted in fewer cases brought to court by the IRS.

Field of Research: Business Law

1. Introduction

Taxpayers generally bear the burden of proof in tax disputes this paper examines the rationales for this state of affairs. It then looks at the legislative changes introduced in the United States and the reasons underlying the impetus for change. A comparison is made with the situation faced by taxpayers in Australia. Both countries have a self-reporting, or self assessment system that places the responsibility on taxpayers to accurately determine their tax liability in the face of heavy penalties should they get it wrong. This paper will discuss the burden of proof in law generally, then as it applies in tax cases in Australia and compare this to the law in the United States both before the passage of the *Internal Revenue Service Restructuring An Reform Act* 1998, (hereafter referred to as the *Reform Act)* and after.

2. Burden of Proof in Law Generally

Parties in an adversarial system must persuade a neutral third party, either judge or jury, to find in their favour. The party with the obligation of persuasion, the one bearing the burden of proof, is usually the one who starts the action. In the words of Lord Justice Bowen, in *Abrath v. No. East. Ry. Co. (*W.R. 50 at 53)

> In order to make my opinion clear, I should like to say shortly how I understand the term 'burden of proof." In every lawsuit somebody must go on with it; the plaintiff is the first to begin, and if does nothing he fails. If he makes a *prima facie* case, and nothing is done by the other side to answer it, the defendant fails.

The burden of proof serves as a practical starting point for resolving a dispute it is a means by which a neutral arbiter can ascertain the existence or nonexistence of the facts. If a party is unable to persuade the neutral arbiter that a fact exists, then that party will have failed to achieve their desired result. As highlighted in *Pacific Portland Cement Co. v Food Mach. & Chem. Corp* (178 F.2d 541 at 547 9th Cir.

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1949) the party upon whom the burden of proof rests will lose if no evidence is given on either side. Confusion over the definition of "burden of proof" exists because the term has been used in a number of cases including *Abilene Sheet Metal, Inc. V. N.LR.B*. (619 F.2d 499, AT 505 5TH Cir. 1985) to describe to distinct aspects of trial proceedings: first the burden of persuasion and second, the burden of production. The burden of persuasion is defined as the obligation of the persuading a trier of fact, whether judge or jury, on the disputed issues in controversy. The party that is deemed to have the burden of persuasion maintains the burden throughout the trial. The burden of production is a procedural device, the party with the burden must produce credible evidence to sustain the case, if the burden of production is not met, the court decides the case and a jury is has no role to play. While the burden of production may shift if a sufficient amount of evidence is presented, in contrast the burden of persuasion is fixed and does not change during the course of a trial, as stated in the *Simpson v. Home Petroleum Corp.* (770 F2d 4999 at 505 5th Cir. 1985)

The rules governing the allocation of the burden of proof can be either fixed by statue or governed by the principles of common law. The broad policy orientated principle of common law for deciding who should bear the burden of proof guided by five rules (Martinez, 1987).

(1) *The Burden of Proof is Assigned to the Party Who Has the Affirmative of the Issue.*
(2) *The Burden of Proof is Assigned to the Plaintiff as to All the Elements of His Cause of Action.*
(3) *The Burden of Proof is Assigned to the Party Who is Alleging a Disfavored Contention.*
(4) *The Burden of Proof is Assigned to the Party Alleging the Least Likely Scenario.*
(5) *The Burden of Proof is Assigned to the Party with Particular Knowledge About the Matter at Issue.*

These principles tend to place the burden of proof on the plaintiff, for example in *Arthur v. Unkart* (96 U.S. 188 1877) the Supreme Court placed the burden of proof on the plaintiff, who was also observed to allege the affirmative of an issue that alleged a disfavoured contention. No ordering of importance in the rules has occurred through precedent, so one overriding principle governs the apportionment of the burden it ultimately depends on the general considerations of fairness, convenience and policy (Kennedy, 1986).

3. The Burden of Proof in Tax Cases

The taxpayer generally has the burden of proof in any tax dispute it is for the taxpayer to demonstrate that the commissioner's assessment is incorrect as demonstrated in *Helvering v. Taylor* (293 U.S. 507 at 515 1934), and furthermore in a refund action, the taxpayer must also establish the amount to which they are entitled. As clearly illustrated in *David v. Phinney* (350 F2d 371 5th Cir. 1965)

> Since the action for refund of taxes is in the nature of a common law action for money had and received and is governed by equitable principles, the burden of proof is upon the taxpayer to prove not only that the determination of the tax was wrong but to produce evidence from which another and proper determination could be made.

And again in the Australian case *Trautwein v FCT* (56 CLR 63 AT 88 1990) Latham CJ held that in order to satisfy this onus, the taxpayer must show not only that the assessment is wrong, but also what correction should be made to make it right, or more nearly right. A significant factor leading in these decisions is the presumption of correctness that attaches to the assessments or determinations of the Commissioner, an assumption derived from the common law of administrative regularity as highlighted in *United States v. Rexach* (482 F2d 10 AT 16 1ST Cir. 1973). However once the taxpayer produces competent and relevant evidence to support his position, the presumption of correctness vanishes and the case must be decided upon the evidence presented, as demonstrated in the *A. & A. Tool & Supply Co. v.* Commissioner (182 F.2d 300 at 304 10th cir. 1950). The presumption of correctness facilitates the collection of revenue. Indeed the government's need for revenue is the most frequently cited reason for placing the burden of proof on the taxpayer. As stated in *Bull v. United States* (295 U.S. 247 at 259-60, 1935)

> [T]axes are the lifeblood of government and their prompt and certain availability an imperious need. Time out of mind, therefore, the sovereign has resorted to more drastic means of collection. The assessment is given the force of a judgement, and if the amount assessed is not paid when due, administrative officials may seize the debtor's property to satisfy the debt. ...Thus, the usual procedure for recovery of debts is reversed in the field of taxation. Payment preceded defense and the burden of proof, normally on the claimant, is shifted to the taxpayer.

4. Taxpayer's Burden of Proof in Australia

Australia has a self-assessment system which has been introduced progressively since 1986 as a fundamental reform to tax administration the system relies heavily on voluntary compliance by taxpayers (Wheelwright, 1997). The Australian Tax Office now issues assessments which generally accept as correct the taxpayers' own calculations of their taxable income and tax liability. For the ATO the emphasis has shifted from the technical scrutiny of tax returns, to past-assessment audits, and data matching techniques. The Commissioner of Taxation was given increased powers in Section 170(2)(b)(i) and (ii) *Income Tax Assessment Act* (1936) (hereafter referred to as *ITAA* (1936)) of including a period of up to four years in which to amend and assessment after it has been issued and tax has been paid or reimbursed, and increased administrative penalties and interest charges where taxpayers have filed to exercise reasonable care as per section 270.

Section 262A of the *ITAA*(1936) require a person, including a company, carrying on a business to keep records that record and explain all transactions and other acts engaged in by the person that are relevant for any purposes of the Act. In particular,

the section requires taxpayers to keep: any documents that are relevant for the purposes of ascertaining the person's income and expenditure and; documents containing particulars of any election, estimate, determination or calculation made by the person under that Act, and particulars showing the basis for and the method by which an estimate, determination or calculation was made.

In addition to the appropriate recordkeeping requirements, taxpayer faces a considerable hurdle in discharging the statutory burden of proof, when seeking a review of an assessment or appealing against an objection decision. If there is a dispute a taxpayer who has documentation about transactions will be better placed to discharge their burden of proof. A taxpayer is required to keep records for five years. Sections 14ZZK (b) and 14ZZO (b) of *Taxation Administration Act* (1953) prescribe that the taxpayer has the burden of proving, on the balance of probabilities that "the assessment is excessive".

The justification put forward for this legislated onus on the taxpayer is that "the true facts of the situation lie uniquely within the taxpayer's knowledge". The burden of substantiation and record-keeping rests heavily with all taxpayers under and self-assessment system, any carelessness and inability to corroborate assertions as to the source of funds may be defeated by the onus of proof, indeed even where as in *Vale Press Pty Ltd v FCT* (29 ATR 207 1994) wherein the Commissioner applied and arbitrary percentage in the sales tax assessment, or as in *Briggs v DFCT* (WA *ex parte Riggs* 18 ATR 570 1987) where the court held that an assessment may go close to guesswork and yet still be lawful.

5. Taxpayer's Burden of Proof in Tax Cases in the United States Pre 1998

In the United States, even though taxation is dominated by *Internal Revenue Code*, the allocation of the burden of proof to taxpayers in district court cases remained in the realm of the common law. The *Code* is silent as to the taxpayer's general burden of proof it does not codify the common law however exceptions to the rule where the Commissioner bears the burden were provided for in legislation in section 7454. The Board of Tax Appeals was created by the *Revenue Act* 1924, the Board operated independently of the district court and the legislation provided it with the power to promulgate rules governing its practice and procedure. The Board promptly placed the burden of proof upon the taxpayer. One of the original appointees of the Board James S. Ivins explained the Board's rationale in adopting a rule, as following the practice of all courts since the beginning of civilization: the moving party, the plaintiff or the initiator of an action, must take the burden of going forward. The Commissioner could not sustain this burden of proof because the taxpayer possessed the relevant evidence. It is worth noting, that the Congress hearings considered *Internal Revenue Service* use of subpoena to obtain relevant evidence to satisfy its burden of proof if the taxpayer were relieved of the burden. A witness representing the American Institute of Accountants, before the 1925 House of Representatives hearing at 908-09, favouring shifting the burden of proof to the government argued:

> There is no reason why the right of the taxpayer should be sacrificed to the convenience of the commission, ...(and that placing the burden on the taxpayer was) contrary to the rule that obtains in any court outside of France.

The common law principle that the party who bears the affirmative of an issue in substance and not mere form, bears the burden of proof, has meant that a taxpayer seeking a refund from the commissioner was asserting the affirmative of an issue and therefore bore the burden of proof. Implicit in this allocation of the burden of proof is that the taxpayer has voluntarily paid the tax to the government, and should therefore bear the burden of explaining any inconsistency in the assessment. The point is often made that the taxpayer should bear the burden of proof simply because he is the plaintiff. *Rockwell v Commissioner* (512 F.2d 882 at 887 9th Cir. 1975) noted that "in most litigation, from time immemorial, the burden of proof-i.e., the burden of persuasion- is on the plaintiff." The taxpayer argued that it was a violation of his due process rights for the Tax Court to impose on him the burden of proof. The court stated that the taxpayer's argument bordered on the frivolous.

In a self-reporting system of tax liability, the taxpayer decides the extent and amount of their statutory obligation to pay tax. The taxpayer is generally in possession of the evidence, and the common law allocation of the burden of proof to the party in possession of the evidence is appropriately applied, in the overwhelming majority of tax cases. In *Weise v Commissioner* (93 F.2d 921 at 923 8th Cir. 1938) the point was clearly stated: "burden of proof on taxpayer where facts and evidence peculiarly within his control and knowledge." The burden of proof exits as a matter of adjudicatory necessity to provide guidance, reduce confusion, and add structure thus the allocation of the burden of proof to the party in possession of relevant knowledge meets this goal, a point made on numerous occasions in cases and in hearings before the congress.

6. Internal Revenue Service Restructuring and Reform Act 1998

President Clinton signed into law the *Internal Revenue Service Restructuring and Reform Act* on July 22nd 1998. President Clinton was not in favour of the proposal in the first instance it was only after the Senate Finance Committee hearings in January and February 1998, that exposed horrendous (Wos-Mysliwiec, 1999) behaviour by the IRS that President Clinton and the Secretary for the Treasury, Robert Rubin, began to support the proposal. IRS agents confessed in the hearings before the Congress in 1997, to an established policy of intimidating weak and poor taxpayers in order to make examples of them. The *Reform Act* had the goal of preventing the IRS from abusing its power and increasing accountability to taxpayers. One of the key ways the Act addressed this goal was by shifting the burden of proof from the taxpayer to the IRS in all court proceedings regarding the determination of tax liability. Throughout the process of the passage of the *Reform Act* legislators focused on the need to shift the burden of proof from the taxpayer to the IRS.

Until the 1976 Congress creation of the Problem Resolution Program to investigate problems and complaints and mediate or recommend solutions as a

neutral agency within the IRS, taxpayers had no recourse other than full scale litigation. This was seen by many tax commentators as a step in the right direction (Conoboy, 2000). Problems still lingered and 1988 Congress enacted the first *Taxpayer Bill of Rights.* The goals of the legislation were to increase taxpayers; awareness of their rights during an audit by the IRS (Meland, 1988). This legislation was also in response to testimony by taxpayers to Congress of maltreatment by the IRS. Problems persisted and in 1996 Congress enacted a second *Taxpayers' Bill of Rights (2 Pub. L. No 104-08 110 Stat. 1452).* This second Bill of Rights focused on procedural safeguards and remedies available to taxpayers, it also established the Tax Systems Modernisation Program. The Program was generally seen as a failure, and taxpayer testimony of abuse at the hands of the IRS continued. This latest bill lead to the creation of the National Commission on Restructuring the IRS, the Commission determined that it was necessary to overhaul the IRS and change the culture from pro-government to pro-taxpayer (Wos-Mysliwiec, 1999). The yearlong audit of the IRS found that the IRS was "fraught with mismanagement, and oversight problems and is unaccountable to Congress and the American people" as reported to Congress in 1997. It is against this backdrop that the 1998 *Reform Act* came about.

The *Reform Act* shifted the burden of proof from the taxpayer to the IRS the aim was to make litigation less difficult for the taxpayer. The Act placed additional requirements on the taxpayer in essence the taxpayer has to fulfil what has been described as the burden of production he must introduce some credible evidence relating to the tax liability in question. Thus the shifting of burden of proof to the IRS, relates to the burden of persuasion. The three requirements placed on the taxpayer in order to shift the burden are: firstly the taxpayer is required to substantiate any item within the requirements of the Code. Secondly, the taxpayer must keep all records in accordance with the Code. Finally, the taxpayer is required to accommodate the IRS in any reasonable requests as to documents, witnesses, meetings, interviews or other information (Henning, 1999). The requirements do not appear to add substantially to the requirements under a self-reporting system. It remains to be seen how the courts interpret the requirements and words such as "reasonable requests." Not all legal commentators see the *Reform Act* as having made the life of taxpayers easier, in the words of Wos-Mysliwiec:

> Despite the noble efforts of many legislators and taxpayer advocates, the Internal Revenue Reform and Restructuring Act of 1998 has unfortunately failed to provide the results it promised. The Act's prerequisites have the effect of enshrining the pro-IRS presumption it sought to eradicate and further complicate tax litigation.

An empirical study was conducted by Gardner and Norman in 2003 on the effectiveness of the shift in the burden of proof in tax cases, following the introduction of the *Reform Act.* The authors looked at data taken from the U.S Tax Courts for the years of 1995 through to 2001. The authors looked to the 1984 work of Priest and Klein to shed light on their outcomes. The assumption underlying Priest and Klein's theory is that in order to get an accurate measure of how often plaintiffs are successful in a particular field of law, it is not sufficient to

examine only the cases brought to trial or appeal because this provides an inadequate sample. To get an accurate measure it would be necessary to take a sample from all the underlying disputes, many of which are not brought to trial, because parties take into account their chances for success before bringing a case to trial. Taking this theory into account, we would expect that the IRS would only bring to trial cases that they were more likely to win, or that were too close of either of the parties to agree to settle. The data supports the conclusion that the IRS brought fewer cases to trial after the passage of the *Reform Act.* It is logical to assume that the shift in the burden of proof caused the IRS to settle some of the cases that they may previously have taken to trial, but it is equally logical that it would also have chosen not to bring some cases that it previously may have brought and settled (Gardner & Norman 2003).

7. Conclusion is the Burden Excessive for Australian Taxpayers?

A Report of the Joint Committee of Public Accounts in 1933 commented that there was no better example of the powers of the ATO and the inferior standing of the taxpayer than the statutory requirement that taxpayer should satisfy the burden of proving their cases. Sections 14ZZK(b) and 14ZZ)(b) have been characterised by tax commentator Warnock as “reversal of the onus of proof” (Warnock, 1992) in that the Commissioner by issuing an assessment is deemed by section 177(1) to have issued a correct assessment, and it if for the taxpayer to prove that the assessment is excessive.

Australian taxpayers do not have a taxpayers’ bill of rights, or a *Reform Act* all they have is a taxpayers’ Charter issued by the ATO. This Charter does not set out to create new rights for taxpayers but rather enunciate rights that are essentially `social’ rights, such as the right to be treated with courtesy, consideration and respect. These rights tend to be subjective in character and difficult to measure. Nonetheless such aspirational rights are important to the climate of cooperation between taxpayer and Revenue authority, and to tax compliance. The reputation of the ATO has at times suffered some criticism, such as immediately following the *Commissioner of Taxation v. Citibank Ltd.* where the raid by the ATO was seen as overkill. However compared to the horror stories recorded in congressional hearings about the tactics of the IRS, the ATO enjoys a favourable reputation. Hence in Australia we cannot rely on an outpouring of scorn against the ATO in order to have our legislature act to lessen the burden of proof on taxpayers. The Australian Law Reform Commission has looked at the operation of client privilege in the tax area however it did not investigate the issue of burden of proof. The Australian Law Reform Commission may take up the issue if the professional accounting associations raise their concerns about the operation of the burden of proof.

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