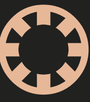

Improper IRS Disclosures of Taxpayer Data under Section 6103: Recovering Punitive Damages Despite No Actual Damages

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In adopting its no-harm-no-foul attitude in *Castillo*, the IRS seems to have overlooked, or perhaps decided not to disclose, some potentially important information.

Introduction

Taxpayers *always* give heaps of confidential data to the Internal Revenue Service ("IRS") when they file their mandatory tax returns and information returns, and the IRS *always* has a legal duty to safeguard such data. Taxpayers *sometimes* become victims of improper disclosures, and the IRS sometimes gets punished for its transgressions.

This article introduces key legal concepts, including specialized Tax Court procedures for challenging IRS collection actions, data-protection duties of the IRS, manners by which aggrieved taxpayers can sue the IRS for breaches, and the potential for triumphant taxpayers to recover not only damages, but also costs incurred in fighting the IRS. This article then analyzes the most recent case in this area, *Castillo v. United States*, which holds that taxpayers might be able to obtain punitive damages from the IRS, even when they do not suffer actual damages because of the IRS's improper disclosure.[1]

Foundational Matters

To understand the significance of *Castillo*, readers must first understand the following tax and procedural concepts.

Collection Due Process Hearings

Within five days *after* filing a lien, the IRS must provide the affected taxpayer a Notice of Federal Tax Lien ("NFTL")

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informing him of various things, including the amount of the liability and his right to request a collection due process ("CDP") hearing.[2] Likewise, the IRS is required to send the taxpayer a Final Notice of Intent to Levy at least 30 days *before* it seizes his property to satisfy tax debts.[3] This, too, informs the taxpayer of his legal right to demand a CDP hearing.

To contest either the NFTL or proposed levy, the taxpayer must file a timely Form 12153 (Request for a Collection Due Process Hearing) with the IRS. The taxpayer is entitled to raise "any relevant issue relating to the unpaid tax or the proposed levy" at the CDP hearing.[4] This includes challenges to the appropriateness of the IRS's collection activities, the applicability of innocent spouse relief, and the taxpayer's entitlement to a payment alternative, such as offer-in-compromise or installment agreement.[5] In cases where the taxpayer did not receive a Notice of Deficiency or have another chance to question the substance of an alleged tax liability earlier, he can do so during the CDP hearing.[6]

The Appeals Officer who conducts the CDP hearing must decide whether the NFTL or proposed levy "balances the need for efficient collection of taxes with the legitimate concern of the person that any collection action be no more intrusive than necessary."[7] It should come as no surprise that Appeals Officers often conclude that the need for swift tax collection is paramount. In such instances, the Appeals Officers issue a Notice of Determination upholding the NFTL or proposed levy. Down but not altogether out, the taxpayer still has the right to seek further review, this time by filing a Petition with, and litigating his case before, the Tax Court.[8]

Protecting Taxpayer Data

Section 6103 generally requires the IRS to safeguard "returns" and "return information" from improper "disclosure."[9] As one would expect, in the spirit of protecting sensitive data, the relevant definitions are broad. The concept of "return" covers any tax return, information return, or claim for refund, as well as all corresponding schedules, attachments, statements, lists, etc.[10] For its part, the phrase "return information" has wide reach. It encompasses the following: (i) A taxpayer's identity; (ii) The nature, source, or amount of a taxpayer's income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, withholdings, deficiencies, and more; (iii) Whether a taxpayer's return was, is, or will be examined or investigated; (iv) Any other data received, recorded, prepared or collected by the IRS about a return or a liability of any person; (v) Any part of a written determination that is not open to public inspection; and (vi) A Closing Agreement or similar document, along with background data.[11] Finally, the term "disclosure" means making known to *any* person, in *any* manner whatsoever, a return or return information.[12]

There are several exceptions to the general prohibition against the IRS disclosing returns and/or return information. Here are a couple. First, IRS personnel ordinarily have access to returns and return information if their official duties require inspection or disclosure for tax administration purposes ("Tax Administration Test").[13] Second, IRS personnel can reveal a return or return information in a judicial or administrative proceeding, provided that such proceeding pertains to tax administration, and the taxpayer is a party to the proceeding ("Party Test").[14] In summary, Section 6103 ordinarily mandates that the IRS cannot disclose, internally or externally, any taxpayer returns or return information, as these concepts are broadly defined. However, the IRS might disregard the general non-disclosure rule when the situation meets the Tax Administration Test, Party Test, or another exception.

Actions Against the IRS for Disclosure Violations

Taxpayers have a remedy in situations where the IRS makes an improper disclosure. Generally, if any IRS employee knowingly or negligently, inspects or discloses, any return or return information, about a taxpayer in violation of Section 6103, then such taxpayer can file a lawsuit in District Court seeking civil damages under Section 7431.[15] Two possible recoveries exist in cases where the District Court holds in favor of the taxpayer. He might get $1,000 for each act of unauthorized inspection or disclosure, plus costs, plus reasonable attorney fees if he is the "prevailing party" under Section 7430.[16] Alternatively, in cases involving willful or grossly negligent violations by the IRS, the taxpayer can obtain payment for actual damages sustained as result of the violation, plus punitive damages, plus costs, plus reasonable attorney fees if he is the "prevailing party" under Section 7430.[17] The taxpayer is entitled to the larger of these two potential recoveries.[18]

Recouping Costs from the IRS

In certain circumstances, taxpayers who defeat the IRS not only free themselves from tax liabilities, they also get absolution in the form of cost reimbursement. This possibility derives from Section 7430, several aspects of which are described below.

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1 *Castillo v. United States*, 129 AFTR 2d 2022-1254 (DC NY 2022).

2 Section 6320(a).

3 Section 6330(a).

4 Section 6330(c)(2)(A).

5 Id.

6 Section 6330(c)(3); Treas. Reg. § 301.6320-1(e)(1); Treas. Reg. § 301.6320-1(e)(3) Q-E2 and A-E2.

7 Conference Report 105-599, 105th Cong., 2d Sess., June 24, 1998, p. 263; Section 6330(c)(3)(C).

8 Section 6330(d); Tax Court Rule 331(b).

9 Section 6103(a).

10 Section 6103(b)(1).

11 Section 6103(b)(2)(D).

12 Section 6103(b)(8).

13 Section 6103(h)(1). The term "tax administration" means (i) the administration, management, conduct, direction, and supervision of the application of federal tax laws and treaties (ii) the development of federal tax policy related to existing or proposed federal tax laws or treaties, and (iii) assessment, collection, enforcement, litigation, publication, and statistical gathering functions under such laws or treaties. *See* Section 6103(b)(4)(A)(i); Section 6103(b)(4)(A)(ii); Section 6103(b)(4)(B).

14 Section 6103(h)(4)(A).

15 Section 7431(a)(1). I.R.M. § 11.3.1.4.3 (11-12-2021).

16 Section 7431(c).

17 Id.

18 Id.

19 H.R. Rep. No. 97-404, 97th Cong., 1st Sess. at 11 (1981).

20 Section 7430(a).

Legislative history indicates that the objective of this provision is to "deter abusive actions or overreaching" by the IRS and "enable individual taxpayers to vindicate their rights regardless of their economic circumstances."[19] Generally, Section 7430 provides that the "prevailing party" in any administrative proceeding before the IRS, or in any litigation that is brought by or against the IRS in connection with the determination, collection, or refund of any tax, penalty, or interest may be awarded reasonable administrative and/or litigation costs.[20] The term prevailing party normally means the party that has substantially won with respect to either the amount in controversy or the most significant issues presented, and has a net worth that does not exceed the statutory thresholds.[21] Even if the taxpayer meets these two criteria, he nonetheless will *not* be deemed the prevailing party if the IRS establishes that its position was "substantially justified."[22]

There is a rebuttable presumption that the IRS's position is *not s*ubstantially justified if the IRS fails to follow "applicable published guidance" during a dispute.[23] Such guidance includes final or temporary regulations, revenue rulings, information releases, notices, and announcements.[24] It also encompasses various items issued to the particular taxpayer involved in a dispute, such as private letter rulings, technical advice memoranda, and determination letters.[25] The regulations provide additional clarity regarding what constitutes a substantial justification. They explain that the IRS's position is substantially justified *only if* it has a reasonable basis in both fact and law.[26] Along with the legislative history and the regulations, case law is helpful in identifying what represents substantial justification. Certain courts have developed a non-exhaustive list of factors to consider. Among these factors are (i) the stage at which the matter is resolved, (ii) the opinions of other courts on the same underlying issues, (iii) the legal merits of the IRS's position, (iv) the clarity of the governing law, (v) the foreseeable length and complexity of the dispute, and (vi) the consistency of the IRS's position.[27] Other courts have utilized a different approach, scrutinizing whether the position taken by the IRS is "justified to a reasonable degree that could satisfy a reasonable person or that has a reasonable basis in both law and fact."[28] Still other courts rely on a different test, framing the question as whether the IRS knew, or should have known, that its position was invalid at the time it took it.[29]

Recent Tax Court Case

With that tax and procedural background under their belts, readers are now ready to tackle the relevant case, *Castillo.*

Background Facts

The taxpayer underpaid her federal income taxes for 2014, though the causes for this are unclear from the facts contained in the District Court's ruling. The IRS, as part of its collection efforts in 2018, issued an NFTL to the taxpayer. The taxpayer challenged one or more aspects of the NFTL by filing a CDP hearing request. Soon thereafter, the taxpayer hired Attorney One to represent her before the IRS. The taxpayer apparently changed her mind regarding defense counsel, terminating Attorney One and hiring, instead, a law professor and the students participating in the tax clinic she oversees ("Attorney Two"). The taxpayer notified the IRS about the replacement of Attorney One by Attorney Two in several ways. First, in September 2018, she sent correspondence to the Appeals Officer handling her CDP hearing indicating the change and instructing the IRS to send Attorney Two copies of all correspondence from that point forward. Second, the taxpayer spoke to the Appeals Officer directly about this during the CDP conference in September 2018. Third, the taxpayer sent a written notification about the role of Attorney Two to the IRS's Central Authorization File ("CAF") Unit, which inputted the data into the Integrated Data Retrieval System ("IDRS"), used by persons throughout the IRS, by early October 2018. Lest there be any doubt concerning knowledge, the CAF Unit even sent the taxpayer a letter expressly confirming the revocation of Attorney One and substitution by Attorney Two.

The taxpayer, through Attorney Two, attempted to reach the Appeals Officer several times after the CDP hearing, presumably to discuss the status, next steps, deadlines, etc. Attorney Two left voicemails for and sent letters to the Appeals Officer; none triggered a response. Therefore, nearly a year after the CDP hearing, in September 2019, Attorney Two ordered a so-called Account Transcript from the IRS showing activity on the taxpayer's record. This revealed to the taxpayer, for the first time, that the Appeals Office had issued a Notice of Determination upholding the NFTL long ago, in early December 2018.

Tax Court Litigation

Within 30 days of learning about the unfavorable Notice of Determination, the taxpayer filed a Petition with the Tax Court challenging it. The IRS attorneys, following normal procedure, lodged an Answer in response to the Petition, attaching a copy of the relevant Notice of Determination. Then, the IRS attorney took steps to dispense with the case immediately. In particular, he filed a Motion to Dismiss, asking the Tax Court to jettison the case because the taxpayer did not file her Petition within 30 days of the date of the Notice of Determination, as required. The Tax Court did so.[30]

District Court Litigation

Ignored by the IRS and rejected by the Tax Court, the taxpayer next turned to the District Court. She filed a lawsuit seeking civil damages from the IRS for

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21 Section 7430(c)(4)(A).

22 Section 7430(c)(4)(B)(i).

23 Section 7430(c)(4)(B)(ii).

24 Section 7430(c)(4)(B)(iv)(I); Treas. Reg. § 301.7430-5(c)(3).

25 Section 7430(c)(4)(B)(iv)(II); Treas. Reg. § 301.7430-5(c)(3).

26 Treas. Reg. § 301.7430-5(c)(1).

27 *National Federation of Republican Assemblies v. United States*, 263 F. Supp. 2d 1372, 1378 (S.D. Ala. 2003).

28 *Wilkes v. United States*, 289 F.3d 684, 688 (11th Cir. 2002).

29 *See, e.g., Downing v. Commissioner*, T.C. Memo 2005-73.

30 *Josefa Castillo v. Commissioner*, Tax Court Docket No. 18336-19L, Order of Dismissal for Lack of Jurisdiction, March 25, 2020.

improper disclosure of her return information in violation of Section 6103.

Main Positions of the Taxpayer

The taxpayer's argument can be paraphrased as follows:

1. She timely notified the IRS in three different ways that she had terminated Attorney One and replaced him with Attorney Two;
2. The Appeals Officer assigned to handle her CDP hearing had both constructive and actual knowledge that Attorney Two represented taxpayer;
3. Nevertheless, the Appeals Officer, with approval from her Manager, sent the Notice of Determination to Attorney One, not to Attorney Two, and not to the taxpayer directly;
4. The Notice of Determination constitutes return information under Section 6103, as it features her identity, new home address, Social Security Number, and more;
5. Sending the Notice of Determination to Attorney One, who was not taxpayer's representative at the time, constitutes improper disclosure;
6. Because of the improper disclosure by the IRS, the taxpayer incurred financial losses in that she was deprived of her chance to present to the Tax Court a "meritorious defense" to the tax liability of approximately $80,000;
7. Because of the improper disclosure by the IRS, the taxpayer also suffered emotional distress; and
8. Because the IRS conceded the most significant legal issue in the case (*i.e.,* that it violated Section 6103 by sending the Notice of Determination to Attorney One), the taxpayer is the prevailing party, and the IRS should be obligated to pay her reasonable fees and costs under Section 7430.

The taxpayer underscored some specifics for the District Court in an effort to demonstrate that the IRS's violations were due to "gross negligence." She alleged, in short, that various employees of the IRS flagrantly ignored policies and protocols designed to prevent the very type of improper disclosure that occurred. For instance, she explained that the Internal Revenue Manual instructs Appeals Officers, Managers of Appeals Officers, and mailroom workers to take certain actions, including reviewing the files and the IDRs, to validate a taxpayer's representative *before* sending a Notice of Determination.

The taxpayer contended that, because of the actions or inactions by the IRS, she experienced various hardships. Among them were the inability to challenge in Tax Court taxes and penalties exceeding $80,000, levies by the IRS of her financial accounts, revocation of her passport by the Department of State, cancelation of her license to drive, stress, insomnia, high blood pressure, and strain on her overall mental health.

Main Positions of the IRS

The IRS conceded many points because, well, it essentially had no choice in view of the evidence. In particular, the IRS admitted that the taxpayer notified the IRS in three different ways of her shift to Attorney Two, the Appeals Officer had actual knowledge of Attorney Two and her role, the Appeals Office sent the Notice of Determination to Attorney One, and such action constituted a violation of Section 6103. The IRS still felt that it had the upper hand, despite these admissions. Therefore, it filed a Motion for Summary Judgment, asking the District Court to rule in its favor without the need for a trial.

The IRS's main positions boiled down to the following:

1. First, the IRS's only violation for purposes of Section 6103 consisted of sending the Notice of Determination to Attorney One, *not* its failure to send the Notice of Determination to Attorney Two and/or the taxpayer.
2. Second, while the taxpayer might have conceivably suffered damages because she did not have a chance to seek review by the Tax Court of the Notice of Determination, such damages did not result from the IRS's narrow violation of Section 6103. In other words, to the extent that the taxpayer experienced damages, they were triggered by the *non-disclosure* of return information to the *appropriate* persons (*i.e.,* Attorney Two and the taxpayer), not by disclosure to the *inappropriate* person (*i.e.,* Attorney One). Lamentably for the taxpayer, she can only recover under Section 7431 for improper disclosure, not for improper non-disclosure.
3. Third, because the taxpayer did not incur actual damages flowing directly from the IRS's violation of Section 6103, she cannot recover punitive damages either, because Section 7431 provides that the former is a prerequisite for the latter.
4. Lastly, even if the taxpayer were entitled to recovery under Section 7431, it would be limited to $1,000 because the IRS's actions were not attributable to "gross negligence."

Reasoning and Rulings by the District Court

The District Court seemed sympathetic to the taxpayer's plight, but it still ruled in favor of the IRS on the major issue. Specifically, it was "constrained to agree" that the IRS's only infraction for purposes of Section 6103 was sending the Notice of Determination to Attorney One, and the taxpayer had not demonstrated any actual damages caused by that improper disclosure. The District Court, in other words, held that it could not compensate the taxpayer for any damages caused by the improper non-disclosure by the IRS; that is, its failure to send the Notice of Determination to the taxpayer or Attorney Two in time for them to challenge it in Tax Court.[31]

Not all things went the IRS's way, however. The District Court discussed the divergence between two Courts of Appeals regarding the types of damages recoverable by aggrieved taxpayers under Section 7431. After noting that it was not beholden to either of the two, the District Court determined that, while Congress certainly could have drafted

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[31] The District Court did not unilaterally mention any other tax provisions under which the taxpayer might have sought recovery from the IRS, such as Section 7433, which allows for legal actions where the IRS recklessly, intentionally, or negligently disregards any tax provision or regulation "in connection with any collection of federal tax with respect to a taxpayer." *See* Section 7433; Treas. Reg. § 301.7433-1.

[32] *In re Molina*, 929 N.Y.S.2d 277 (2011), 88 A.D.3d (2011). To be clear, the author is not certain whether Attorney One is the same individual who is the subject of the cited case and/or whether he engaged in the actions discussed.

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Section 7431 more artfully, such provision is not ambiguous on its face. It means that, when a taxpayer demonstrates an improper disclosure under Section 6103, the IRS should pay her $1,000 per violation, or the sum of the actual damages and punitive damages, whichever amount is larger. The District Court put it the following way: The taxpayer's "failure to plead facts sufficient to raise a plausible inference that she sustained *actual damages* does *not* preclude her from seeking *punitive damages* in this case."

The District Court then criticized the IRS for attempting to "downplay and trivialize" the taxpayer's allegations about misconduct by various IRS employees in violating Section 6103. The District Court emphasized that the taxpayer credibly claimed that the Appeals Officer, her Manager, and mailroom staff all disregarded numerous procedural safeguards designed to prevent the type of improper disclosure that happened in this case. The District Court also noted that the allegations suggest "more than a single, simple error, and more than a lack of ordinary care." Accordingly, the District Court denied the IRS's Motion for Summary Judgment, forcing the issue to trial.

Finally, the District Court kept open the possibility of the taxpayer recovering not only punitive damages under Section 7431, but also reasonable fees under Section 7430. Because the IRS already admitted its violation of Section 6103, and because the taxpayer might present at trial sufficient evidence of "gross negligence" by the IRS to warrant punitive damages, the District Court reasoned that it was premature to let the IRS off the hook for the taxpayer's administrative and legal fees. In concluding that a trial is necessary to address the matter, the District Court hinted that it planned to pay special attention to whether the IRS disobeyed its own "applicable published guidance" in sending the Notice of Determination to Attorney One. If so, this would prompt a rebuttable presumption that the IRS's position was not substantially justified.

Food for Thought

In adopting its no-harm-no-foul attitude in *Castillo*, the IRS seems to have overlooked, or perhaps decided not to disclose, some potentially important information. In particular, the individual to whom the Appeals Officer admittedly made the disclosure of confidential data in violation of Section 6103, Attorney One, might be the same person who was previously criminally convicted and publicly censured for, among other things, illegally accessing "confidential tax records" while working at the New York State Department of Taxation and Finance.[32] Both have the same name, live in the same city, and work in the same area of law. This could be nothing more than coincidence, but if it is not, the District Court might take this fact into account when deciding the magnitude of punitive damages to impose against the IRS.

Conclusion

Castillo teaches important lessons to both parties in a tax dispute. Taxpayers learn that legal actions brought under Section 7431 have their limits, specifically that they only cover disclosure of confidential data by the IRS to inappropriate persons, not non-disclosure of such data to appropriate persons. The IRS, for its part, discovered that in actions under Section 7431 it might be liable for punitive damages and litigations costs, even in situations where taxpayers do not suffer actual damages from the IRS's privacy violations.