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“SUBSTANTIAL JUSTIFICATION” FURTHER DEFINED BY PHILLIPS

by

JEROME S. HORVITZ*

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INTRODUCTION

The Tax Court in *Phillips* (referred to as *Phillips II*¹) has set helpful guidelines for making a determination of when the IRS has taken a position which is not substantially justified. This is one of the tests that must be satisfied before a court of proper jurisdiction can grant a motion for litigation costs pursuant to Section 7430. *Phillips II* also addresses the issue of settlement attempts, and whether they are needed to exhaust administrative remedies, which is a further requirement for Section 7430 treatment. The following discussion describes the legislative purpose of Section 7430 and its effectiveness in promoting fee-shifting. Attention will be focused upon *Phillips* and other cases in analyzing the tests of Section 7430.

The complexity of the Code has become increasingly evident over the past decade.² Complexity causes confusion, and this leads to increased tax litigation. Another cause for the increase in tax litigation is the IRS's aggressive posture on compliance. Consequently, the cost of litigation must now be considered in conjunction with the hazard of litigation. Furthermore, for individual taxpayers Code Section 212(c) now limits the deductibility of court costs to amounts in excess of two percent of adjusted gross income.

In deciding whether to litigate an issue, the taxpayer has to contend with not only the costs of attorney's fees, but also numerous other expenses such as payment for expert witnesses, travel costs, jury fees, filing fees, etc. The high cost of litigation may deter many smaller taxpayers from pursuing an issue which has merit. This

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¹ The *Phillips* case is analyzed as a two stage process. The first stage is labeled *Phillips I*, *Phillips v. Commissioner*, 86 T.C. 433 (1986). The second stage is referred to as *Phillips II*, *Phillips v. Commissioner*, 88 T.C. 529 (1987), which is the Section 7430 claim for court costs.

² Economic Recovery Tax Act of 1981 (ERTA), Pub. L. No. 97 - 34; Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97 - 248; Subchapter S Revision Act of 1982, Pub. L. No. 97 - 354; Technical Corrections Act of 1982, Pub. L. No. 97 - 448; Tax Reform Act of 1984, Pub. L. No. 98 - 369; Internal Revenue Code of 1986, Pub. L. No. 99 - 514.

causes inequity and puts the taxpayer at a disadvantage. It seems especially harsh that the taxpayer should be out of pocket by a significant amount when the Government takes a position which is not substantially justified. One remedy available to the taxpayer is Section 7430, which allows access to reimbursement for most of these court costs.

LEGISLATIVE HISTORY

Generally, in the absence of specific statutory authority, court costs were not recoverable in civil tax litigation. Prior to the passage of Section 7430, the courts had carved out an exception. In *Alayeska Pipeline Service Co. v. Wilderness Society*,³ the U.S. Supreme Court held that attorney's fees could be awarded to a prevailing party if the losing party acted in "bad faith, vexatiously, wantonly, or for oppressive reasons". In response to this decision Congress enacted statutes that provided authority to award attorney's fees in civil tax litigation.⁴

The Civil Rights Attorney's Fees Award Act of 1976⁵ represents the first time Congress recognized the need to award court costs in civil tax litigation. Under this statute, reasonable attorney's fees could be awarded at the court's discretion to prevailing parties other than the Government. However, this statute was inapplicable to the majority of civil tax cases since it was not available to litigation in Tax Court.

Later, several bills were introduced in Congress seeking to make the Government liable for attorney's fees in civil tax cases. None of these legislative initiatives became law, largely due to Congress' uneasiness at the high projected cost if a statute of this nature were enacted.⁶ Concern over the potential burden generated by a fee-shifting statute was frequently expressed during Congressional hearings.⁷ Eventually, Congressional debates led to legislation that became the Equal Access to Justice Act.⁸

Equal Access to Justice Act

The Equal Access to Justice Act (here-in-after, EAJA) awarded a prevailing taxpayer attorney's fees if the litigating position of the Government was not substantially justified.⁹ Congress felt that the principal goal of the EAJA was to reduce deterrents to litigation, i.e. to give citizens the ability and incentive to

³ 421 U.S. 240 (1975).

⁴ 28 U.S.C. § 2412.

⁵ 42 U.S.C. § 1988.

⁶ H.R. REP. NO. 96-1418, 96th Cong. 2d Sess. (1980), p. 6.

⁷ *Id.*

⁸ *Supra* note 4.

⁹ 5 U.S.C. § 504 (a) (1) (Supp. 1983).

challenge, instead of submitting to, unreasonable Governmental action.¹⁰ A problem frequently cited by Congressional proponents of the EAJA was the capacity of the government to single out and pursue certain taxpayers. One of the systematic sources of inequity cited by advocates of the EAJA was the ability of the government to use its superior resources to intimidate smaller taxpayers. The scenario often described in the legislative history was that of agency officials concentrating their enforcement effort on small businessmen who lack the money to acquire legal assistance to effectively resist a tax deficiency.¹¹ Consequently, the intent was that many of the beneficiaries of the EAJA would be small proprietors. Congress felt that subsection to unusually harsh treatment by regulatory authority such as the IRS could be devastating.

A three-year sunset clause provided for automatic repeal of this provision on October 1, 1984. Judicial interpretation of the law made this provision inapplicable to litigation in Tax Court.¹² Since the vast majority of tax litigation occurs in Tax Court, few taxpayers were successful in obtaining fee awards pursuant to the EAJA.¹³

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)¹⁴ revised the law relating to awards for attorney's fees by adding Section 7430 to the Internal Revenue Code (here-in-after, Code). Again, it was felt that fee shifting was necessary to deter abusive actions or overreaching by the Government and to enable the taxpayer to vindicate his rights regardless of economic circumstances. In spite of its noble purpose, Section 7430 contains several restrictive requirements and definitions that limit attorney's fees and other costs awarded to prevailing taxpayers. These restrictions were addressed by Congress in the Technical Corrections Act of 1988 which incorporated the Taxpayer's Bill of Rights.¹⁵

Burden of Proof

One of the restrictions is the burden of proof. The Tax Reform Act of 1986 (TRA '86) amended Section 7430 to have it conform more closely to the provisions of the Equal Access to Justice Act.¹⁶ One exception was the fact that the Tax Reform

¹⁰ See H.R. REP. NO. 1418, 96th Cong., 2d Sess. 9 (1980); S. REP. NO. 253, 96th Cong., 1st Sess. 1, 4 (1979); H.R. REP. NO. 1434, 96th Cong., 2d Sess. 25 (1980) (Conference report), *reprinted in* 1980, U.S. CODE CONG. & ADMIN. NEWS, 4953.

¹¹ Congress' concern was that "[i]n far too many cases, a party will buckle under a federal order he knows to be wrong because he cannot afford the cost of taking the matter to court." 125 Cong. Rec. 21441 (1979) (Statement of Senator Thurmond).

¹² M. Garbis, P. Junghans, & S. Struntaz, *FEDERAL TAX LITIGATION: CIVIL PRACTICE AND PROCEDURE*.

¹³ P. Dingle, *Examining Unreasonable IRS Behavior and The Award of Attorney's Fees in Tax Cases: Underlying Action v. Litigation Position*, *FLORIDA LAW REVIEW*, 1017 (1985).

¹⁴ Pub. L. No. 97-248, 96 Stat 324.

¹⁵ Technical and Miscellaneous Revenue Act of 1988, *see*; *Taxpayer Rights And Obligations, Proceedings by Taxpayers*, Act Section 6239 (a).

¹⁶ *Supra* note 9.

Act of 1986 did not shift the burden of proof from the taxpayer to the Government as it was originally enacted in the EAJA.¹⁷ The Taxpayer's Bill of Rights¹⁸ seriously considered shifting the burden of proof back to the Government to establish that its position was substantially justified. However, as finally enacted, the burden was not shifted. If one were to read these Section 7430 cases, one may conclude that the courts do not take much notice of the burden of proof issue. There appears to be no *presumption* that the Government acts with substantial justification. In short, the courts review each situation independently and they make a separate determination by reviewing the taxpayer's Section 7430 motion and the Government's response.

Eligibility

The Tax Reform Act of 1986 adopted the provision contained in the EAJA restricting those taxpayers eligible to receive an award. An individual is not eligible if his net worth exceeds \$2 million at the time the litigation is instituted. The owner of an unincorporated business, or any partnership, corporation, association, local governmental unit or organization is not eligible if its net worth exceeds \$7 million and if it has more than 500 employees at the time of litigation. The net worth restriction does not apply to exempt organizations under Section 501(c)(3) and certain agricultural cooperative associations.¹⁹

In order to be eligible for an award under Section 7430, a court must determine that:

1. the taxpayer proved that the position of the Government in the proceedings was not substantially justified,
2. the taxpayer exhausted the administrative remedies available to him, and
3. the taxpayer "substantially prevailed" in the proceeding.

The above requirements will be analyzed in light of judicial interpretation in successive order below.

Substantial Justification

As noted above one of the requirements contained in the EAJA was that the taxpayer must be "substantially justified" in his position in order to be eligible for reimbursement of attorney's fees. Effective for cases commenced on or after March 1, 1983, the EAJA was superseded by new Code Section 7430. Section 7430, as originally enacted, stated that court costs are awarded where the Government's litigating position was "unreasonable." TRA' 86 substituted the standard of

¹⁷ *Id.*

¹⁸ H.R. 1313, 100th Cong., 1st Sess. (1999), and S. 2233, 100th Cong., 1st Sess. (1988).

¹⁹ I.R.C. § 7430 (c) (2) (A) (iii).

"unreasonable position" with the "substantial justification" standard originally found in the EAJA. With the passage of the Taxpayer's Bill of Rights this standard remained intact.²⁰ Since Congress has chosen not to define these standards their interpretation has been left to judicial examination.

In *Russell v. National Mediation Board*,²¹ the Fifth Circuit Court of Appeals reviewed the standard of "substantial justification" in cases brought under the EAJA. The Fifth Circuit found that the test of whether or not a Government action is substantially justified is essentially one of "reasonableness," and requires the Government to establish that its position has a reasonable basis both in law and in fact.²² On the other hand, there is little direction in the Section 7430 cases with respect to interpreting the "unreasonableness" standard. Consequently, some courts²³ turned to the more extensively litigated question of whether the Government's position was "substantially justified" as interpreted under the as suggested in *Kaufman v. Egger*,²⁴ and thereby bringing the standards of review closer together. Until there is further judicial clarification the "substantially justified" test and the "reasonableness" test are treated interchangeably.

It appears that the principal barrier in a taxpayer's attempt to effectuate fee-shifting remains in establishing that the position of the IRS was not substantially justified. In short, the burden of proof remains on the taxpayer.²⁵ Rather than articulate a determinative test for unreasonableness, Congress enumerated the following criteria to be evaluated in conjunction with legal precedent and the facts in a given case: (1) whether the Government used the costs and expenses of litigation against its position to extract concessions from the taxpayer that were not justified under the circumstances of the case, (2) whether the Government pursued the litigation against the taxpayer for purposes of harassment or embarrassment, or out of political motivation, and (3) such other factors as the court finds relevant.²⁶

An effort by the Government to sustain a position in a particular Circuit Court which previously ruled for the taxpayer on the same issue would represent a typical example of unreasonableness.²⁷ By contrast, the Government's attempt to create a conflict among the Circuit Courts is not considered unreasonable.²⁸ Consequently,

²⁰ *Supra* note 15.

²¹ 775 F. 2d 1284 (5th Cir. 1985).

²² In *Gavette v. Office of Personal Management*, 785 F. 2d 1568, 1579 (5th Cir. 1986) the Fifth Circuit defined the phrase "substantially justified" as used in the EAJA as meaning "clearly reasonable."

²³ See *Giesecke v. United States*, 637 F. Supp. 309 (1986); *Kansas City Southern Transport Co. v. United States*, No. 271-85T, U.S. Claims Court (1986). Cf., see *C.H. Golden*, 34 F. 2d 367 (10th Cir. 1986) which followed the rationale of *Keasler v. United States*, that the taxpayer must show that the Government acted unreasonably which is a different standard than under the EAJA.

²⁴ 584 F. Supp. 872, 877 (1984).

²⁵ 26 U.S.C. § 7430 (c) (2) (A) (i).

²⁶ H.R. REP. NO. 97-404, 97th Cong., 1st Sess. 12 (1981).

²⁷ Mandelkern, *Recovering Attorney's Fees in Tax Court Cases after TEFRA*, THE FLORIDA BAR JOURNAL, 707-10 (1983).

²⁸ Technical Explanation of Committee Amendment, 127 Cong. Rec. S15577, S15594 (daily ed., Dec. 16, 1981).

to obtain an award of court costs under Section 7430, the taxpayer must prove the Government's awareness that its litigation position was clearly inconsistent with the facts of the case or controlling legal precedent or there is outright administrative bungling which violates any standard of fair play.²⁹ While the prevailing party requirement may appear to be *de minimis*, the taxpayer must also prove that all administrative remedies have been exhausted.³⁰

Since 1982, 145 cases involving litigation of the award of court costs have been decided. For example, in 1982, only one case was decided, while in 1987, 36 cases were disposed of. This is a substantial increase in the requests for relief by taxpayers. One of the most contested issues in these earlier cases was whether the pre-litigation position of the Government should be considered. This issue was resolved by TRA '86. A review of some of the more recent decisions may shed some light on what it takes to convince a court of proper jurisdiction that the Government was in fact unreasonable.

In the principal decision of *Phillips*, "dummy" returns were filed according to Section 6020(b) for 1979, 1980 and 1981 by the IRS for the taxpayer. The IRS took the position that these returns were "separate returns" within the meaning of Section 6013(b) (1). However, the taxpayer was married to a non-resident alien at the close of the years in question. Pursuant to Section 6013(g), the taxpayer and his wife elected "married filing joint return" status for these returns, and the resultant use of foreign tax credits wiped out any tax liability for these years.

The sequence of events in *Phillips I* is as follows:

1. "Dummy" returns are filed for taxpayer in 1982 for the years in question, and no tax is assessed for these years.
2. On May 18, 1983, the IRS issues a statutory notice of deficiency for the 3 years under examination.
3. On October 12, 1983, the taxpayer files a petition in Tax Court.
4. On the same day the taxpayer files his petition in Tax Court, he files income tax returns for 1979, 1980 and 1981 as joint returns.
5. The IRS does not process these returns.

The Tax Court sustained taxpayer's position that the original returns were not valid returns according to Section 6020 and, consequently, the restrictions of Section 6013(b)(2)(B), (the 3-year statute of limitations) and Section 6013(b) (2)(C), (filing

²⁹ United States v Beebe, 88-1 U.S.T.C. Paragraph 9115, p. 83, 042.

³⁰ I.R.C. § 7430 (b) (1).

a petition in Tax Court after issuance of a statutory notice of deficiency) did not apply. Consequently, the taxpayer was justified in electing to file a joint return in accordance with Section 6013(a).

In taking this position, the Tax Court had to overrule its decision in *Durovic*³¹ (which was decided in 1970 and was sustained by the Seventh Circuit on appeal).³² *Durovic* held that, regardless of any previous filing, a taxpayer is barred from filing a joint return after the IRS sends a statutory notice of deficiency (90-day letter). In 1972 and 1983 the IRS had issued Rev. Rul. 72-539³³ and Rev. Rul. 83-183.³⁴ These rulings held that where no return is filed prior to the return on which joint return status is claimed, the limitations of paragraph 2 of subsection (b) of Section 6013 are *inapplicable* and, therefore, the taxpayers were correct in filing joint returns.

The inconsistency of the Government's position in not following its own rulings was held to be capricious in *Phillips II*. Although the Government relied on *Durovic*, it was determined in *Phillips I* that reliance on case law was unreasonable because of the Government's "articulated administrative position" on the later election to file joint returns as stated in Revenue Rulings 72-539 and 83-183. In fact, the Tax Court reprimanded District Counsel for litigating the case in the face of these rulings without first withdrawing or modifying them. Thus, the taxpayers were granted Section 7430 relief.

There was an aggressive dissent taken in *Phillips II* because they felt it was not unreasonable for the IRS to rely on *Durovic*. *Durovic* was relied upon for sixteen years until it was overruled by *Phillips I*. But more importantly, the dissent felt that, absent special circumstances, a revenue ruling merely represents the position of the IRS in regard to a particular factual situation. The dissent concluded that rulings may be adopted or rejected according to the pleasure of the courts, and consequently, they do not represent "substantive authority" or have legal precedent.³⁵

If one were to accept the posture taken by the dissent in *Phillips II*, would its rationale be sustained in a situation where the Government takes a position inconsistent with itself in another program, such as the acquiescence program which was instituted to respond to adverse Tax Court decisions?³⁶ For example, in *Giesecke v. United States*,³⁷ a taxpayer was successful in deducting certain business expenses incurred as a result of promoting the career of a San Antonio chanteuse. The IRS disagreed with Giesecke's characterization of the expenses spent on promotion as business expenses, and disallowed the deduction on the taxpayer's

³¹ *Durovic v. Commissioner*, 54 T.C. 1364 (1970).

³² Affirmed on this issue 487 F. 2d 36 (7th Cir. 1973).

³³ 1972-1 C.B. 634.

³⁴ 1983-2 C.B. 220.

³⁵ *Supra* note 1, *Phillips II* at 534.

³⁶ H.B. Quinn 524 F. 2d 617 (7th Cir. 1975), 75-2 U.S.T.C. Paragaph 9764 (7th Cir. 1974).

³⁷ *Supra*, note 21.

return. In this instance, the District Court felt that the Government failed to present evidence that proved that Giesecke's situation was any different from the facts demonstrated in the decision of *Levy v. Commissioners*³⁸ The Court in *Giesecke* held that the Government failed to show why the *Levy* precedent should not have been followed since the factual situation in both cases as the same. This is particularly true since the IRS had issued a formal acquiescence to the *Levy* decision back in 1958.³⁹ The Court held that the Government should have been bound by its own official policy that it would follow *Levy*. Thus, the decision to litigate the same issue was held not to be substantially justified in *Giesecke*. Especially if one notes that both *Levy* and *Giesecke* were within the same jurisdiction of the Fifth Circuit Court of Appeals.⁴⁰

The acquiescence program is made available to the public so that the IRS is not bound by adverse Tax Court decisions which it decides not to appeal. An acquiescence to a particular decision is acceptance of the result but not necessarily the reasons given by the Court.⁴¹ It stands to reason that the dissenters in *Phillips II* would take the same posture in *Giesecke*, and that is, if the Government takes an inconsistent position with a prior Tax Court decision for which there is an acquiescence, its current posture is not necessarily unreasonable or not substantially justified. One must remember that rulings and acquiescence can be revoked prospectively as well as retroactively, without explanation regardless of whether there was taxpayer reliance.⁴² Therefore, can one say that the IRS is bound by its own administrative pronouncements even though they do not have precedent setting value?

For example, in *R. R. Mearkle*⁴³ the IRS had issued proposed regulations on the ceiling limitation for expenses related to an office-in-the-home. These regulations had been struck down by the Tax Court in its decision in *Scott*.⁴⁴ Consequently, in response to *Scott*, the IRS decided not to litigate the issue. When the Government took this position, the taxpayers motioned for court costs because they felt that the proposed regulations were inconsistent with the Code (as sustained by *Scott*), and therefore, the IRS had taken a position that was not substantially justified.

In disallowing court costs, the Tax Court held that both the Government and the taxpayers alike are justified in relying on regulations until they are struck down.⁴⁵ Since the Government has a mandate to enforce the revenue laws pursuant to Section 7801, issuing regulations is in keeping with this mandate. Consequently, it was felt

³⁸ 30 T.C. 1315 (1958).

³⁹ 1959-1 C.B. 1, 4.

⁴⁰ In a sense, a form of an estoppel argument has been developed in *Giesecke* and in other Section 7430 cases.

⁴¹ See "Rules and Regulations" discussion in CCH Standard Federal Tax Reporter, 1988, Vol. 9, p. 67,036, par. 5980 A.013.

⁴² *Dixon v. United States*, 381 U.S. 68 (1965).

⁴³ 87 T.C. 527 (1986).

⁴⁴ *Scott v. Commissioner*, 84 T.C. 683 (1985).

⁴⁵ *Supra* note 1, *Phillips II*, at 533.

that reliance on a *proposed* regulation has no distinguishable value from a final regulation when applying the substantial justification test under Section 7430.⁴⁶ Therefore, the Court refused to allow Sections 7801 and 7430 to conflict with each other.

One interesting issue skirted by the Court in *Mearkle* was whether continued reliance on a judicially disapproved regulation is an unreasonable position for purposes of Section 7430? In *Mearkle*, the Government conceded its case three months after *Scott*. What would have been the consequences if the Government had not conceded? Obviously, since the Tax Court is not a court of last resort, it might take years before the validity of a regulation is finally determined. Consequently, is it unreasonable for the Government to continue to rely on *invalidated* regulations?

In *Mearkle*, the Tax Court made reference to this issue in a footnote by stating:⁴⁷

Although we need not decide the issue, it is possible that the Commissioner may reasonably rely on regulations until long after they are struck down, depending on which court has struck down the regulation, whether any others have upheld it, where the litigation is taking place, and the force behind the Commissioner's argument in favor of the regulation's continuing validity.

Even though regulations can be revoked they have priority in relation to other IRS pronouncements in that they have precedent setting value until they are invalidated.⁴⁸ Whether other IRS administrative pronouncements will have precedent setting value in Section 7430 cases is yet to be determined. It was clear in *Phillips II* that published revenue rulings have such standing.

Administrative Remedies

Reasonable administrative costs that are recoverable in an administrative proceeding within the IRS are (1) any administrative fees or similar charges imposed by the IRS and (2) the reasonable expenses incurred with respect to compensating expert witnesses, financing necessary studies and reports, and paying attorney's fees, based upon prevailing market rates for the kind or quality of services furnished. The IRS determines the reasonableness of attorney's fees and the cost of studies and reports incurred in administrative proceedings.⁴⁹

In determining whether the position of the Government was substantially justified, the position of the Government will be determined as of the earlier of two dates: (1) the date of the receipt by the taxpayer of the notice of the decision of the

⁴⁶ *Supra* note 1, *Phillips II*, at 532.

⁴⁷ *Supra* note 1, *Phillips II*, at 532.

⁴⁸ *Supra* note 1, *Phillips II*, at 530.

⁴⁹ *Supra* note 15.

IRS Office of Appeals or (2) the date of the notice of deficiency. If neither date is applicable, the position of the Government will be the position taken in the litigation.⁵⁰

As mentioned above, Code Section 7430(b) requires the taxpayer to exhaust the administrative remedies before seeking relief. Regulation Section 301.7430 sets forth the circumstances that the IRS will normally consider when administrative remedies are exhausted. Before the taxpayer files either a petition in Tax Court or refund claim in U.S. District Court, an Appeals Conference must be requested. Consequently, the taxpayer has to agree to extend the statute of limitations for assessment by signing Form 872.⁵¹

Before an Appeals Conference is granted a 30-day letter is normally issued to the taxpayer so that a protest can be filed. It is the 30-day letter that opens the door for a conference with the Appeals Division. Once a conference is granted by Appeals, Regulation Section 301.7430-1(b) (2) requires the taxpayer to disclose "all relevant information ... known at the time of the conference." It is assumed that an otherwise reluctant taxpayer must request a conference at Appeals regardless of his litigation strategy. However, what happens if either the notice of audit, the 30-day letter and/or the 90-day letter (statutory notice of deficiency) is not mailed or received by the taxpayer? Is the taxpayer excluded from the benefits of Section 7430 because the IRS does not send these notices to the taxpayer's last known address as required by Section 6212(b)?

To answer these questions a distinction must be made between pre-petition versus post-petition status. Regulation Section 301.7430-1(f) (2) states that with post-petition status, failure to receive a preliminary notice of proposed deficiency (30-day letter) will not preclude the application of Section 7430 if the failure to receive the notice was not due to "actions of the party." One such "action" referred to is the failure to send a current mailing address to the District Director. Therefore, with post-petition status there is an affirmative requirement that the taxpayer notify the IRS of an address change. Thus, the IRS has had to live with its own administrative errors in some Section 7430 cases. A good example of the consequences of an administrative error in a Section 7430 case occurred in *Kaufman v. Egger*.⁵²

In *Kaufman*, the District Court would not allow an administrative error to preclude a remedy under Section 7430. In this case, the taxpayers filed their individual income tax return for 1978 with the Chicago district. Shortly thereafter, the taxpayers moved to Maine. A couple of years later, the IRS sent a notice to the

⁵⁰ *Supra* note 15.

⁵¹ If a taxpayer does not extend the statute of limitations for assessments, the IRS will issue a 90-day letter (statutory notice of deficiency).

⁵² 584 F. Supp. 872, aff'd on other grounds, 758 F. 2d 1 (1st Cir. 1985).

Kaufmans that their 1978 return was to be audited. The Kaufmans never received this notice because it was sent to their former Chicago residence. Consequently, the Kaufmans did not show up for their appointment, so the IRS proceeded with an assessment.

The notice of the assessment was sent to an Illinois address where they had never lived. A few years later, the IRS had connected the 1978 deficiency matter with the correct taxpayers and sent them a notice informing them that the IRS was seizing a refund from their 1982 return. After they found out that the matter had been referred to the Taxpayers Delinquent Account Section, the Kaufmans commenced legal proceedings. The Court ruled that there is no question but that in this case the IRS's bureaucratic mixup was unreasonable by *any standard*, and awarded the Kaufmans' attorney's fees.

One must not be deceived by the conclusion in *Kaufman* since the requirement of Section 6212(b) is easily satisfied when the IRS mails notices to the taxpayer's address shown on the most recently filed return. However, if a taxpayer receives the 90-day statutory notice of deficiency as the only notice, a petition can be filed in Tax Court and, while the case is pending the Appeals Division has jurisdiction for a limited time. Is it at this time that taxpayer must request a conference? Will this request satisfy Regulation Section 301.7430?

As already mentioned the distinction between pre-petition versus post-petition status is made in the regulations. When the case is in pre-petition status it is solely an administrative proceeding.⁵³ With post-petition status the case is in its litigation stage. Since the Appeals Division must consider the hazard of litigation most cases are settled at this point. Consequently, the settlement procedure can be satisfied at Appeals or when District Counsel has jurisdiction over the matter. If the taxpayer does not make a satisfactory offer or the IRS does not sign a statutory waiver (Form 870AD), is the taxpayer precluded from the benefits of Section 7430?

Rev. Proc. 87-24⁵⁴ stipulates that once a case is docketed with the Tax Court, it must be sent to the Appeals Division for settlement unless the 90-day statutory notice of deficiency had been issued by the Appellate Division in the first place. If no progress towards settlement is made the case is returned to District Counsel. There is nothing in Rev. Proc. 87-24 which limits the time for consideration of the case either by the Appellate Division or District Counsel. However, once the case appears on the trial calendar, it must be returned to District Counsel. Then Counsel has sole settlement authority, unless Counsel and the Appellate Division agree that settlement authority over some (or all) of the issues is to be retained by the Appellate Division. Finally, when there is a significant issue or a large deficiency, the

⁵³ I.R.M. 8711 (2) MT 8-17 (Jan. 18, 1980). See M. Saltzman, IRS PRACTICE AND PROCEDURE, Paragraph 9.06[1] (1983).

⁵⁴ 87-1 C.B. 720.

Appellate Division and District Counsel have joint jurisdiction until the case is settled or settlement appears unlikely.

Regulation Section 301.7430-1(f)(2)(ii) deals directly with a post-petition Appellate Division conference by requiring the taxpayer to "participate" in the conference. The requirement to have the taxpayer "participate" in the post-petition Appeals Division conference reduces litigation costs by fostering settlement attempts. Thus, the extent of a taxpayer's participation in a post-petition conference is relevant when deciding whether additional litigation costs could have been avoided.

In *Phillips II*, the Government claimed that the taxpayer did not avail himself for an Appeals Division review as required by Section 7430(b) (2). The Court noted that the issue of filing status was the only issue under examination, and this was not brought to taxpayer's attention until he received the statutory notice of deficiency and with the docketing of the case in Tax Court. In fact, the taxpayer was in communication with the Appeals Division and District Counsel before the case went to trial. It was the IRS's own intransigence or refusal to consider Rev. Ruls. 72-539 and 83-183 that made settlement of the case futile. In fact, Congress noted that the IRS's unwillingness to compromise lowers the standard of exhaustion of administrative remedies, and should be applied less *strictly*.⁵⁵ However, can the taxpayer intentionally provoke the IRS into intransigence to avoid the administrative requirement of Section 7430(b)(2)? The court in *Phillips II* stated that the taxpayer could not turn his back on an opportunity to settle.⁵⁶ Of course, if the IRS notifies a taxpayer that the issue or issues is a litigation vehicle, then it would be inappropriate and basically impossible for the taxpayer to attempt a settlement. The fact that there is a high hazard of litigation for either party does not necessarily mean that settlement is required. A party may go forward with litigation with the hope that a former decision may be overturned (which occurred in *Phillips I*), or there may be a change in statute or appellate review. The issue of pursuing unnecessary litigation was addressed at length by the Eighth Circuit in *Keasler v. United States*.⁵⁷

In *Keasler*, the taxpayer had sued for a refund for excise taxes assessed on certain truck hoist units manufactured by taxpayer. The taxpayer had motioned for summary judgment based on the holding in *Jacobs Equipment Co. v. United States*.⁵⁸ which was a Tenth Circuit decision with identical facts. *Jacobs* had been decided in 1978, and the District Court granted the taxpayer's motion in 1981 based on the rationale in *Jacobs* - even though the District Court's decision in *Keasler* was appealable to the Eighth Circuit and not the Tenth Circuit. After summary motion was granted, the taxpayer petitioned for court costs under Section 2412(d) of the

⁵⁵ H.R. No. 97-404, 97th Cong., 1st Sess. 13 (1981).

⁵⁶ *Supra* note 1, *Phillips II*, at 533.

⁵⁷ 766 F. 2d 1227 (8th Cir. 1985).

⁵⁸ 574 F. 2d 1040 (10th Cir. 1978).

EAJA. The taxpayer was indeed awarded court costs and the Government appealed. On appeal, the Eighth Circuit sustained the District Court's decision.

Keasler is important because it appears to conflict with *Phillips II*. In *Keasler*, the Government had relied on a published revenue ruling to assess the excise taxes in question. The Government's reliance on this ruling was not considered substantially justified when the Government went to litigation because it was in direct conflict with the *Jacobs* decision. This result is peculiar because the Government in *Keasler* did exactly what it was chastised for not doing in *Phillips II*, and that was to rely on its own administrative pronouncements even though it was in conflict with a particular court. In fact, the Eighth Circuit mirrored the dissent in *Phillips II* when it dismissed the value of rulings as "simply the contention of one of the parties to the litigation,"⁵⁹ and that they did not have the force of legal precedent.

The inconsistency between *Phillips II* and *Keasler* may be resolved by the fact that the specific ruling relied upon by the Government in *Keasler* represented a shifting and unstable position. However, regardless of the validity of the ruling in *Keasler*, the sanctity of legal precedent is open for questioning in Section 7430 claims. The rationale in *Keasler* was that the Eighth Circuit normally gives deference to other circuits in regard to tax disputes, and this deference was known by the Government in *Keasler* when it pursued litigation in the face of *Jacobs*.⁶⁰ Consequently, it was felt that, if the Government wants to pursue or create conflicts in the circuits, it should not be at the expense of the taxpayer.⁶¹

As stated above, the legislative history of Section 7430 demonstrates that pursuing a conflict among the circuits is not an unreasonable litigation posture for the Government. Also, a decision in one circuit does not collaterally estop the Government from litigating the same issue in another circuit. In fact, inter-circuit conflict is usually needed for Supreme Court review. In *Keasler*, the Eighth Circuit justified its holding by stating that the award of court costs would not "chill" the Government from seeking modification of established doctrine in other circuits.⁶² It felt that if the issue is important enough, government officials would not be dissuaded by the prospect of an award of fees to a private party's counsel. At any rate, the Court did not think it appropriate for private litigants to subsidize such "reevaluations."⁶³

⁵⁹ *Supra* note 57, at 1233.

⁶⁰ The Fifth and Seventh Circuits have a similar policy. The purpose of giving deference to other Circuits in tax matters is to promote uniformity of tax administration. Consequently, with these Circuits, another Circuit's decision must be followed unless it is clearly erroneous. See *Gulf Inland Corp. v. United States*, 570 F. 2d 1277, 1278 (5th Cir. 1978); *Federal Life Insurance Company v. United States*, 527 F. 2d 1096, 1097 (7th Cir. 1975); *Goodenow v. Commissioner*, 238 F. 2d 20, 21 (8th Cir. 1956).

⁶¹ *Supra* note 57, at 1235 - 1238.

⁶² *Id.*; *Spencer v. N.L.R.B.*, 712 F. 2d 539, 559 (D.C. Cir. 1983), *cert. den.* - U.S. -, 104 S. Ct. 1908 (1984).

⁶³ *Id.*

Prevailing Party

One of the final requirements of Section 7430 is that the taxpayer be the "prevailing party."⁶⁴ At first blush, this requirement would appear nominal in relation to the other requirements of Section 7430. In *Phillips II* the IRS argued that, under the meaning of Section 7430(c)(2)(A)(ii), the taxpayer was not a prevailing party because the main issue for consideration was the taxpayer's unreported income.⁶⁵ However, this issue turned on the filing status of the returns in question, and since joint return status was allowed, there was no tax liability. Since prevailing as to the most significant issue and prevailing as to the amount in controversy are alternate grounds for concluding whether the taxpayer is a "prevailing party," the Court held that the taxpayer had indeed prevailed on *both* grounds.⁶⁶

The prevailing party issue connotes an estoppel argument which can be illustrated in the application of Code sections that deal with tax liability that is joint and several.⁶⁷ The fact that the IRS may assess a deficiency against one taxpayer does not enjoin an assessment against a subsequent taxpayer. For example, in *U.S. Life Title Insurance Company of Dallas*⁶⁸ it was held that the IRS was substantially justified in continuing to collect corporate unpaid withholding taxes from a responsible officer under Section 6672 even though it had already collected the full amount from another responsible person.

The *US Life Title Insurance Co.* case was decided under the EAJA, so the Government bore the burden of proving that its position was substantially justified. The Government contended that until the limitations period for seeking a refund expired, it could not be determined with certainty whether the Government would be entitled to retain the funds it has collected. The six-year period for collecting the liabilities assessed against the remaining responsible persons could expire while the first responsible person's refund claim is still pending. In this situation, if the Government is prohibited from pursuing collection activities against the other responsible persons, a successful claim for a refund to one of the responsible persons could have the effect of defeating collection of the full amount of the underlying taxes.

Thus, a premature cessation of collection efforts against a taxpayer would have forced the Government to rely on payments made by the other officer to satisfy the delinquency, despite the possibility, albeit in hindsight nonexistent, that it might be called upon to refund taxpayer's payments. The Court ruled that to uphold an award of attorney's fees in this case would penalize the IRS for doing nothing more than

⁶⁴ I.R.C. § 7430 (c) (2).

⁶⁵ *Supra* note 1, *Phillips II* at 531.

⁶⁶ *Supra* note 1, *Phillips II* at 532.

⁶⁷ For example, see Sec. 6013 dealing with joint returns; Sec. 6901 dealing with transferee liability; and Sec. 6672 dealing with responsible officers.

⁶⁸ 784 F. 2d 1238 (5th Cir. 1986).

carrying out its statutory mandate.⁶⁹

Contrary to *U.S. Life Title Insurance Co.*, is *C. H. Golden v. United States*⁷⁰ where an assessment of the 100-percent responsible officer penalty was asserted against the taxpayer and his wife (which was processed as an off-set against the wife's claim for a refund) was held not to be substantially justified. At trial a jury decision was rendered against the Government, and a default judgment was made against the true responsible officer. With hindsight, the Court weighed heavily the fact that the Government never took appropriate action against the true responsible officer, even though the taxpayer was in charge of payroll and had made payments to creditors. The Court did not mention or entertain the argument used in *U.S. Life Title Insurance*, that the Government was justified in exercising its statutory responsibility to collect taxes or that the Government might get whipsawed by the statute of limitations on collections if it had pursued its case against only one responsible officer. The fact that an off-set was asserted against the wife shows the subsequent exposure that results from joint and several liability.⁷¹ Of course, affirmative defenses are available, but this process may exasperate litigation costs even further.

Litigation Costs

Prior to passage of TRA '86, Section 7430 provided that the prevailing party may be awarded a judgment for reasonable litigation costs, but not in excess of \$25,000. This limitation applied regardless of the number of parties to the proceeding or the number of tax years at issue.

When the Tax Reform Act of 1986 was passed, Congress substituted the \$25,000 cap on the award of attorney's fees with a \$75 an hour limitation (unless a court determines that a higher rate is justified).⁷² A special factor justifying an increase might be the limited availability of qualified attorneys for such proceedings.⁷³ However, an expert witness can not be compensated at a rate in excess of the highest rate of compensation for expert witnesses paid by the Government.⁷⁴

Code Section 7430(c) provides that reasonable litigation costs include:

1. expenses for expert witnesses not to exceed the highest rate paid by the Government,

⁶⁹ *Id.* at 1245.

⁷⁰ 34 F. 2d 367 (10th Cir. 1986).

⁷¹ See transferee liability under I.R.C. § 6901.

⁷² I.R.C. § 7430 (c) (1) (A) (ii).

⁷³ I.R.C. § 7430 (c) (1) (A) (ii) (III).

⁷⁴ I.R.C. § 7430 (c) (1) (A) (ii) (I)

2. costs for a necessary study or analysis, engineering report, test or project.
3. attorney's fees not to exceed \$75 per hour, unless a higher rate is justified because of *special factors* such as limited availability of qualified attorneys.

The definition of attorney fees includes services of an individual who is authorized to practice before the Tax Court or before the IRS will be treated as fees for the services of an attorney. This provision applies regardless of whether the individual is actually an attorney.⁷⁵

In the recent decision of *Rogers v. Commissioner*,⁷⁶ the Tax Court discussed some of the special factors that can be considered in resolving the issue of reasonable attorney's fees. They include:

1. time and labor required,
2. novelty of the case,
3. the skill requisite to performing the legal services,
4. preclusion of other employment by the attorney due to acceptance of the case,
5. the customary fee,
6. whether the fee is fixed or contingent,
7. time limitations,
8. the amount involved and the results obtained,
9. the experience and reputation of the attorney,
10. the "undesirability" of the case,
11. the nature and length of the professional relationship with the client, and
12. awards in similar cases.

⁷⁵ I.R.C. § 7430 (c) (1) (B).

⁷⁶ 53 T.C.M. 1473 (1987).

These factors were derived from the ABA Code of Professional Responsibility, Disciplinary Rule 2-106 (1980), and were judicially recognized in *Johnson v. Georgia Highway Express, Inc.*⁷⁷ and sustained by the Supreme Court in *Hensley v. Eckerhart*.⁷⁸ Also, one must note that the *Johnson* decision occurred before the \$75 per hour cap was instituted. However, these factors are still relevant because of the relief provision of Section 7430(c)(1)(ii) (III) that applies for Section 7430 actions filed after December 31, 1985, and for amounts paid after September 30, 1986.

In the recent decision of *Trahan v. Regan*,⁷⁹ the District Court of Washington, D.C. determined what is considered reasonable attorney's fees by citing *Hensley v. Eckerhart*⁸⁰ which stated:

The most useful starting point for determining the amount of a reasonable fee is the number of hours reasonably expended on the litigation multiplied by a reasonable hourly rate. This equation results in a 'lodestar' figure.

It must be noted that the petitioners in *Trahan* wanted an upward adjustment beyond the \$75 per hour rate ceiling. Their argument was based on cost of living increases, the quality of the representation, and the successful result.⁸¹ In denying the motion for an upward adjustment, the Court stated "that upward adjustments are warranted only in cases of 'exceptional success'".⁸² The court conceded that this is a "heavy burden" upon those who motion for attorney's fees in excess of the \$75 per hour lodestar figure.

There is nothing in Section 7430 which precludes the recovery of litigation costs resulting from a motion for litigation costs under Section 7430. The Third Circuit in *Lee v. Johnson*⁸³ responded to this question by holding that fees incurred to obtain an award of court costs are not recoverable unless the Government's reason for objecting to an award of litigation costs itself is unreasonably under the. The *Lee* standard seems circuitous because once a taxpayer establishes that the Government has acted unreasonably in its original cause of action, it should follow that it was acting unreasonable in opposing the motion of litigation costs under Section 7430. The Tax Court in *Rogers* refused to express any opinion as to whether such an additional test of unreasonableness is required.

One interesting aspect of *Phillips II* is the reduction in the award of court costs because of the taxpayer's own delinquent behavior. As was discussed above, the taxpayer in *Phillips* had not filed tax returns for the years in question, and had

⁷⁷ 448 F. 2d 714, 717-19 (5th Cir. 1974).

⁷⁸ 461 U.S. 424, 429-30 (1983).

⁷⁹ 88-1 U.S.T.C. Par. 9119, p. 83,058, (1988), *aff g* 87-2 U.S.T.C. Par. 9535.

⁸⁰ 461 U.S. at 433.

⁸¹ *Supra*, note 79 at 83,061.

⁸² *See* *Blum v. Stenson*, 465 U.S. 886 (1984).

⁸³ 799 F. 2d 31, 39-40 (3rd Cir. 1986).

requested the IRS to file these returns pursuant to Section 6020(a). These returns were later classified as “dummy” returns and were not recognized as being legitimate for purposes of Section 6020(b). In overturning *Durovic*, the Tax Court allowed the taxpayer to elect joint return status. The point being is: if the taxpayer had not been negligent in filing its tax returns in the first place, *Phillips II* may not have occurred. As the Court stated in *Phillips II*,⁸⁴

“It is in large measure petitioner’s own delinquency that resulted in some of the attorneys’ fees for which he seeks reimbursement. We believe that the United States should not bear the costs of litigation attributable to petitioner’s own wrongful action even though he substantially prevailed on the amount in controversy and on the issue presented for decision. We believe that petitioner should not be awarded fees and costs incurred because of his delinquency; these fees and costs are not reasonable within the meaning of Section 7430(a).”

As already noted, the Tax Court did award court costs due to the Government’s intransigence. But the clock began to run only from the point in time that the Government first took an unreasonable position. Therefore, one may conclude that those Section 7430 cases that deal primarily with administrative errors may have a contributory negligence issue present. For example, if the taxpayers in *Kaufman* had notified the Government of their current address they would have been precluded from petitioning for court costs. With hindsight and with later review of Government actions, (or inactions) the issue of contributory negligence must be resolved. Also, with the passage of the Taxpayer’s Bill of Rights no award of litigation and administrative costs are allowed when the proceeding is unreasonably protracted by the taxpayer.⁸⁵

CONCLUSION

The authors believe that the cost of fee-shifting may have a significant impact on prelitigation and postlitigation strategy. It is undoubtedly true that the availability of Section 7430 has set a new standard, which, if breached, triggers a form of “damages” to the taxpayer. In a sense, Section 7430 actions are akin to tort claims without the problem of governmental immunity.

As the number of Section 7430 cases increases a body of law is forming that has and will continue to define this new standard. The discussion above has tried to bring some sense to the application of Section 7430. The question that remains is whether Section 7430 should be considered a hazard of litigation when settling cases whether before or after the case is docketed with a view towards litigation.

As was seen in the Regulations, the requirement that the taxpayer exhaust

⁸⁴ *Supra* note 1, *Phillips II* at 535.

⁸⁵ *Supra* note 15.

administrative remedies should dampen some of the enthusiasm to pursue Section 7430 actions. This restriction was included in Section 7430 as a prophylactic action to prevent frivolous claims. Consequently, the taxpayer cannot adopt a strategy of "silence" and still seek the benefits of Section 7430. On the other hand, the Government cannot take a position that is intransigent, and still expect the taxpayer to pursue an unnecessary administrative appeal.

The question that remains unanswered is: when does the taxpayer incorporate Section 7430 into a course of action? This is difficult to answer. For example, in *Phillips II*, the Tax Court had the benefit of hindsight (which is the situation with every Section 7430 case) when it reviewed the Government's prelitigation posture. Unfortunately, neither the taxpayer nor the Government can predict the outcome of any potential Section 7430 action. Consequently, these actions must constitute an additional hazard of litigation. The impact of this measure will undoubtedly be felt at the Appeals Division, regardless of whether the case has been docketed. In *Giesecke*, the Court cited the *Hallam* decision as authority that a Section 7430 issue may arise at any stage.⁸⁶

A court should not look at the IRS's position at one isolated point in the litigation process, but should consider the entire process; and if the Court finds that the IRS received information in the course of the process that should convince it to drop the litigation, then it is unreasonable for the IRS not to drop the litigation upon the receipt of such information.

For the taxpayer, the best course of action is to seek administrative review, in good faith, without compromising the merits of the case while still preserving a possible Section 7430 claim if the Government should take a position at any time that is not substantially justified prior to or after initiating litigation. Also, a possible Section 7430 claim can conceivably be used as a bargaining chip. Therefore, it is highly advisable to fully document all administrative actions that may constitute capricious behavior.⁸⁷ Finally, the taxpayer must assess any contributory negligence issue that might arise because of taxpayer oversight.

When applying Section 7430 to the litigation stage there appears to be confusion in regard to the controlling force of rulings and other administrative pronouncements. Clarification on this issue is particularly needed, especially if one looks at the seemingly conflicting views of *Phillips II* and the Eighth Circuit in *Keasler*. It may be very appropriate for the Eighth Circuit and other Circuits to give deference to another Circuit. But what does the litigant do if there is a split in other Circuits - *outside* of the circuit where the original cause arose? The scenarios of litigation strategies are as complex as the cases discussed above have demonstrated.

⁸⁶ *Hallman v. Murphy*, 586 F. Supp. 1, 3 (1983).

⁸⁷ Since the Taxpayers Bill of Rights allows for the audible recording of conferences, it is suggested that conferences be recorded to help preserve any potential Section 7430 action.

Exceeding the bounds of reasonableness is an issue that has not been fully understood or addressed.