

Seeking Cost Reimbursement In Cases Of First Impression: Zealous Advocacy or Pushing Your Luck?

by Hale E. Sheppard



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AFTER A HARD-FOUGHT BATTLE against the IRS, a victory for the taxpayer, and thus for her legal counsel, is extremely gratifying. The triumph becomes even sweeter, though, when the disputed issue is unique or novel. Indeed, what attorney wouldn't enjoy creating new law or expanding existing law while representing a taxpayer in a "case of first impression"? This characterization may be pleasing initially, but it could generate negative consequences later on. In particular, having the case depicted as cutting-edge by the courts may hinder the taxpayer's ability to recoup certain administrative or litigation costs from the government (*i.e.*, the IRS or the Tax Division of the U.S. Department of Justice) under section 7430. (All section references in this article refer to the Internal Revenue Code of 1986, as amended.) This article examines whether seeking reimbursement for the taxpayer in cases of first impression constitutes zealous representation until the bitter end or simply pushing your luck.

OVERVIEW OF COST REIMBURSEMENT

• Generally, the prevailing party in any administrative proceeding before the IRS or in any litigation in the U.S. district courts, the Tax Court, or the U.S. Court of Federal Claims that is brought by or against the government in connection with the determination, collection, or refund of any tax, interest, or penalty may be awarded reasonable administrative and/or litigation costs. §7430(a). Recoverable administrative costs may include charges imposed by the IRS, reasonable attorneys' fees, reasonable expenses for expert witnesses, and reasonable costs of any study, analysis, report, test or project necessary for the preparation of the taxpayer's case. §7430(c)(2). The litigation costs for which the taxpayer may seek reimbursement follow similar guidelines. §7430(c)(1).

The term "prevailing party" generally means a party in any tax-related administrative proceeding or litigation that (i) has substantially prevailed with respect to either the amount in controversy or the most significant issue or set of issues presented; and (ii) has a net worth that does not exceed certain statutory thresholds. §7430(c)(4)(A). Even if the taxpayer substantially prevails and meets the net worth requirement, she will not be deemed the "prevailing party" if the government establishes that its position was "substantially justified." §7430(c)(4)(B)(i). In other words, if the government manages to prove that the position it took during the administrative dispute or litigation was substantially justified, then the taxpayer is precluded from recovering her costs. Understanding what constitutes a substantial justification, therefore, is paramount.

Until 1996, the burden was on the taxpayer to demonstrate that the government's position was *not* substantially justified. This radically changed with the enactment of the Taxpayer Bill of Rights 2, which shifted the onus to the government. P.L. 104-168. According to congressional reports, "the successful taxpayer will receive an award of attorney's fees unless the IRS satisfies its burden of proof."

H.R. Rep. 104-506, 104th Cong., 2d Sess. 1996, pg. 37. This legislation introduced another major change: it required the IRS to follow its published guidance disseminated to the public, as well as its private guidance provided to particular taxpayers. P.L. 104-168, §701; H.R. Rep. 104-506, 104th Cong., 2d Sess. 1996, pgs. 36-37. If it fails to do so, it runs the risk of lacking an acceptable justification for a proposed tax treatment. Congress further advanced the issue in favor of the taxpayers in 1998 with the passage of the Taxpayer Bill of Rights 3. P.L. 105-206. This legislation empowered the courts to take into account whether the government has lost on similar issues in appellate courts for other circuits in determining if the government's position is substantially justified. P.L. 105-206, §3101, *codified as* §7430(c)(4)(B)(iii). The relevant congressional reports reveal the purpose for this increased pressure: Congress was concerned that the IRS would continue to litigate issues that have been previously decided in other circuits. H.R. Rep. 105-364, 105th Cong., 1st Sess. 1997, pg. 58; Sen. Rep. 105-174, 105th Cong., 2d Sess., 1998, pg.48. Such stubborn litigiousness would, say the reports, place an undue burden on those taxpayers forced to dispute decided issues. *Id.*

Rebuttable Presumption

The legislative modifications discussed above have been incorporated into the Internal Revenue Code and corresponding Treasury regulations. The general rule still stands that a taxpayer will not be considered a "prevailing party," and thus will not be entitled to reimbursement, if the government's position was substantially justified. §7430(c)(4)(B)(i). However, there is now a rebuttable presumption that the government's position is *not* substantially justified if it failed to follow its "applicable published guidance" during a proceeding. §7430(c)(4)(B)(ii). Such guidance includes regulations (final or temporary), revenue rulings, information releases, notices, and announcements. §7430(c)(4)(B)(iv)(I); Treas.

Reg. §301.7430-5(c)(3). 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. §7430(c)(4)(B)(iv)(II); Treas. Reg. §301.7430-5(c)(3). In deciding whether the position taken by the government was substantially justified, the courts are instructed to consider whether it lost on similar issues in federal appeals courts. §7430(c)(4)(B)(iii).

What Is “Substantial Justification”?

The regulations provide additional clarity regarding what constitutes a substantial justification. For instance, they explain that the government’s position is substantially justified only if it has a reasonable basis in both fact and law. Treas. Reg. §301.7430-5(c)(1). A significant factor in making this determination is whether the taxpayer presented all of the relevant information under her control to the appropriate IRS personnel. Treas. Reg. §301.7430-5(c)(1); Treas. Reg. §301.7430-5(h) Ex. 1. This seems logical because a taxpayer should have little room to complain about the government’s position when she fails to provide the information, documentation, and arguments necessary to support her own stance. The regulations also contain rules for situations where a position is partially justified. If the government’s position was substantially justified with respect to some (but not all) of the issues, then the taxpayer may only be entitled to reimbursement for those issues for which the government lacked adequate justification. Treas. Reg. §301.7430-5(c)(2). Similarly, if the government’s position was substantially justified for some (but not all) of an administrative or court proceeding, then the taxpayer may be limited to those costs associated with the portion of the proceeding for which the government was short on justifications. *Id.*

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 be considered. Among these factors are:

- The stage at which the issue or litigation is resolved;
- The opinions of other courts on the same underlying issues;
- The legal merits of the government’s position;
- The clarity of the governing law;
- The foreseeable length and complexity of the litigation; and
- The consistency of the government’s position.

National Fed’n of Republican Assemblies v. United States, 263 F. Supp. 2d 1372, 1378 (S.D. Ala. 2003). Other courts have used a different approach, scrutinizing whether the position taken by the IRS was reasonable. *See, e.g., Kennedy v. Commissioner*, 89 T.C. 98 (1987) (holding that the IRS’s position was unreasonable when it acted contrary to its own regulations, contrary to case law, and without factual support). These courts hold that a position is substantially justified if it is “justified to a reasonable degree that could satisfy a reasonable person or that has a reasonable basis in both law and fact.” *Wilkes v. United States*, 289 F.3d 684, 688 (11th Cir. 2002). Still other courts rely on a different test, presenting the question as whether the government knew or should have known that its position was invalid at the time it took it. *See, e.g., Downing v. Commissioner*, T.C. Memo 2005-73. Applying these fact-intensive elements and amorphous standards is challenging on a normal basis. It becomes even trickier, though, in cases of first impression.

A LOOK AT CASES OF FIRST IMPRESSION

- In the majority of cases of first impression, the courts do *not* award the taxpayer administrative and litigation costs under section 7430. *See, e.g., Oak Knoll Cellar v. Commissioner*, T.C. Memo 1994-396; *Stebco Inc. v. United States*, 939 F.2d 686 (9th Cir. 1990); *TKB Int’l, Inc. v. United States*, 995 F.2d 1460 (9th Cir. 1993); *Nalle v. Commissioner*, T.C. Memo 1994-182; *Estate of Wall v. Commissioner*, 102 T.C. 391 (1994); *Spriggs v.*

United States, 660 F. Supp. 789 (E.D. Va. 1987); *George v. United States*, 666 F. Supp. 962 (E.D. Mich. 1987); *Estate of Goree v. Commissioner*, T.C. Memo 1994-542; *Mid-Del Therapeutic Center, Inc. v. Commissioner*, T.C. Memo 2000-383; *Rowe v. Commissioner*, T.C. Memo 2002-136; *Auto-Ordinance Corp. v. United States*, 14 Cl.Ct. 295 (1988); *Kreidle v. IRS*, 145 B.R. 1007 (D. Colo. 1992); *Rhoades, McKee and Boer v. United States*, 846 F. Supp. 565 (W.D. Mich. 1994); *Spires v. United States*, 920 F. Supp. 140 (D. Or. 1996); *Dietz Corp. v. United States*, 1990 WL 175113 (N.D.N.Y. 1990); *Russell v. United States*, 1992 WL 133904 (W.D. Mo. 1992); *M-S News Co., Inc. v. United States*, 1994 WL 461282 (D. Kan. 1994); *Spires v. United States*, 920 F. Supp. 140 (D. Or. 1996); *Smokey Mountain Secrets, Inc. v. United States*, 1996 WL 774554 (E.D. Tenn. 1996); *L.S. Vines v. Commissioner*, T.C. Memo 2006-258; *Marré v. United States*, 117 F.3d 297 (5th Cir. 1997).

The gist of such cases is that the government should not be penalized economically for taking a particular position in uncharted waters. Cognizant of this favorable presumption, the government frequently attempts to categorize cases as groundbreaking. For instance, in *Portillo v. Commissioner*, 988 F.2d 27 (5th Cir. 1993), the IRS issued the taxpayer a notice of deficiency based solely on a Form 1099 submitted by a third party who had no documents to corroborate the amount that he supposedly paid the taxpayer. The appellate court eventually determined that the IRS's notice of deficiency was arbitrary, erroneous, and lacking substantial justification. In an attempt to avoid having to reimburse the taxpayer's costs, the government argued that the court decision created a "new rule." In other words, the government suggested that its position was justified because it was an issue of first impression. The court rejected this "new rule" contention, pointing out that Supreme Court cases dating back to 1935 have held that when an assessment is made without any foundation, it is not entitled to the presumption

of correctness ordinarily conferred to a notice of deficiency. The government has made similar (unsuccessful) arguments in other cases, too. *See, e.g., Currell v. United States*, 2001 WL 1480294 (S.D. Ohio 2001) ("Defendant argues that the facts in the instant case created a case of first impression in the Sixth Circuit and that such cases create a presumption that the government's position is justified.")

Few Defenses Where The Answer Is Obvious

As discussed above, the government's position will ordinarily be considered substantially justified when the underlying issue is one of first impression. However, the Tax Court has noted that "[t]his is not a per se rule." *Downing v. Commissioner*, T.C. Memo 2005-73. The following cases bear this out.

Perry v. Commissioner

The sole issue in *Perry v. Commissioner*, T.C. Memo 1990-123, was whether the proceeds from insurance policies on the life of the decedent, which were paid directly to his sons as owners and beneficiaries of the policies, were properly excluded from his estate for federal estate tax purposes, even though he signed the insurance applications as the proposed insured and paid all of the relevant premiums. Unsurprisingly, the government contended that the insurance proceeds should be included in the decedent's gross estate, while the estate took the opposite approach. While the case was pending, the Tax Court and the Tenth Circuit Court of Appeals issued opinions in other cases that were "virtually identical" to *Perry*. The courts held that the proceeds from an insurance policy were *not* includable in the insured's gross estate because the insured did not possess the requisite incidents of ownership. Following these cases' reasoning, the *Perry* court ruled in favor of the estate since the legal issues in all the cases were indistinguishable.

The government appealed. *Estate of Perry v. Commissioner*, 927 F.2d 209 (5th Cir. 1991). The Fifth Circuit Court of Appeals explained that *Perry*, like the two earlier cases, was based mainly on the plain wording of the relevant statutes, *i.e.*, sections 2035 and 2042. These provisions show Congress's clear intent to eliminate the premium-payment test as the standard for determining if life insurance proceeds must be included in the gross estate of the insured. Accordingly, the Fifth Circuit affirmed the Tax Court's earlier decision favoring the estate.

The estate then filed an action seeking reimbursement for the costs it incurred during the appeal. *Estate of Perry v. Commissioner*, 931 F.2d 1044, 1046 (5th Cir. 1991). The government contended that it was substantially justified in filing the appeal, even though this occurred *after* the adverse court rulings were made. In short, the government acknowledged the harmful cases, but suggested that the issue was still one of first impression in the Fifth Circuit because of a case decided years *before* Congress changed the law to clearly indicate that whoever paid the premiums was not the decisive issue. The Fifth Circuit flatly rejected this argument, held that the government lacked substantial justification, and awarded fees to the estate. In doing so, the appellate court explained the following:

When Congress adopts a new law the clear and unequivocal language of which unmistakably overrules a holding of an earlier case, the absence of a new decision recognizing the obvious does not equate with unsettled law or first impression in the context of this matter . . . [When] the Commissioner elects to ignore the clear wording of a Congressional amendment to the Code, he does so at the risk of incurring the obligation to reimburse such taxpayers for attorneys' fees pursuant to the provisions of Section 7430. 931 F.2d at 1046.

Nalle v. Commissioner

The court in *Nalle v. Commissioner*, 55 F.3d 189 (5th Cir. 1995), found that the government was substantially justified; however, it elaborated on the

standards described in *Perry*. Citing its earlier decision, the court reiterated that when Congress enacts a new law the clear language of which makes the government's position untenable, the lack of a court ruling confirming the obvious does not convert the issue into one of first impression. *Id.* at 193. The court also explained that if a regulation is "manifestly contrary" to the plain meaning of the relevant statute, or if it obviously alters the scope of the statute, the government should know that the regulation is invalid or unjustifiable. *Id.* Finally, in an effort to assuage the concern that statutory interpretation will become analogous to the one-free-bite rule for dog owners under tort law, the court emphasized the importance of reasonableness at all times:

Because we maintain the requirement that the [IRS] have some rational basis for [its] regulations even on issues of first impression, we avoid [the taxpayers'] dire prediction that the first challenge to any regulation will be "free of charge" to the [IRS] no matter how egregious the regulation. *Id.* at fn. 14.

Wilkes v. United States

In *Wilkes v. United States*, 289 F.3d 684, 689-690 (11th Cir. 2002), the decedent died testate in 1988. A large portion of his estate consisted of stock, which the executor agreed to sell to an employee stock ownership plan ("ESOP"). The stock sale occurred in 1989, thereby generating a tax liability of approximately \$500,000. The law in effect at that time (*i.e.*, section 2210(a)) essentially provided that if the executor transferred securities to an ESOP, made the appropriate election, and timely filed an agreement confirming that the ESOP would pay the applicable taxes, then he would be liberated from the estate tax liability. Specifically, section 2210(a)(3) stated that "the executor is relieved of liability for payment of that portion of tax...which such [ESOP] is required to pay."

The executor complied with section 2210(a), but the ESOP failed to pay the taxes. The IRS,

therefore, attempted to collect from the estate. The estate paid the full amount due, filed a claim for refund, and eventually filed a suit for refund after its claim was denied. The district court ruled in favor of the estate, holding that section 2210 discharged the tax liability of the executor in his representative capacity. In particular, it stated that “relief of the executor in his representative capacity is relief of the estate.” 289 F.3d at 688. The district court also granted the estate’s motion for cost reimbursement under section 7430 because the government’s position lacked substantial justification.

The government appealed to the Eleventh Circuit. The government maintained that, until this case, there was no case law directly addressing whether section 2210 relieved the executor of tax liability in his representative capacity or only in his personal capacity. Thus, reasoned the government, it was an issue of first impression not suitable for cost reimbursement. The appellate court rejected this argument because the effect of section 2210 was clear from the ordinary and natural meaning of the key terms, the statutory context, the regulations, and related provisions.

[I]n view of the fact that all of the above mentioned considerations of statutory construction point clearly to the interpretation that the term “executor” refers to the executor in his representative capacity, and in view of the fact that the government has advanced on appeal only the mere possibility that the term “executor” could mean personal capacity without advancing any plausible reasons why it should have that meaning, we cannot conclude that the district court abused its discretion in holding that the government’s position lacked substantial justification.

Id. at 689-690.

Mitchell v. Commissioner

In *Mitchell v. Commissioner*, T.C. Memo 2000-145, the IRS determined that the taxpayers were liable for certain income tax deficiencies, interest, and accuracy-related penalties based primarily on its conclusion that the taxpayers’ home was in Cali-

fornia rather than Illinois. At trial, the court ruled in the taxpayers’ favor, deciding that their tax home was actually in Illinois. The taxpayers then sought cost reimbursement. The court’s decision on this issue was mixed. It held that the IRS’s position with respect to the situs of the tax home was not unreasonable or unjustified because the case was the first to interpret an amendment to section 162(a) as it applied to independent contractors. The court felt differently with respect to the accuracy-related penalties, though. It ruled that the IRS was off base when it imposed sanctions in such a novel case. The court stated, in particular, that “[w]e do not believe it reasonable for respondent to assert an accuracy-related penalty under section 6662(a) in a case of first impression involving the unclear application of an amendment to the Internal Revenue Code.” *Mitchell v. Commissioner*, T.C. Memo 2000-145.

Novel Issues May Fetch Larger Fees

The previous segment demonstrates that the government may be responsible for reimbursing a taxpayer’s costs when it takes a position devoid of substantial justification in novel cases. To make matters worse for the government, courts have held that such situations warrant paying attorneys higher fees, or for additional hours, or both. It all comes down to what is reasonable in cases addressing new issues that have serious future implications for taxpayers.

The term “reasonable costs” generally includes reasonable attorneys’ fees based on the prevailing market rates for the kind or quality of services furnished by the attorney. §7430(c)(1)(B). These fees may not exceed a relatively low hourly limit, unless the court determines there was a “special factor” that warrants surpassing the statutory maximum. §7430(c)(1)(B)(iii). Examples of such factors are a lack of qualified attorneys, the difficulty of the issues in the case, or a limited amount of local tax experts. *Id.* The regulations contain a slightly different standard, providing that “special factors” do

not include the novelty or difficulty of the issues, the work and ability of counsel, the results obtained, and customary fees in other cases. Treas. Reg. §301.7430-4(b)(3)(iii)(B). They also state that specially qualified representatives are those possessing a distinctive knowledge or a unique skill that is necessary to adequately represent the taxpayer in the proceeding. Treas. Reg. §301.7430-4(b)(2)(ii). In the context of cost reimbursement, neither knowledge of tax law nor experience representing taxpayers before the IRS constitutes distinctive knowledge or a unique skill. *Id.*

Despite these seemingly strict standards, the courts have awarded taxpayers larger-than-normal fees when their cases involved issues of first impression. In *Christian Coalition Int'l v. United States*, 133 F. Supp. 2d 437 (E.D. Va. 2001), the taxpayer mounted a first-ever constitutional challenge to section 501(c)(4), dealing with tax-exempt entities. As a basis for awarding cost reimbursement, the court stated that:

Preparation for a landmark case requires extensive research and analysis, especially when faced by an opponent with unlimited resources. If successful, the [taxpayer] and other similarly situated organizations could have received tax benefits for at least seven years, presumably at considerable cost to the United States in lost revenue. An unfavorable ruling would have dealt a devastating blow to the [taxpayer] who for practical reasons may not have been able to claim entitlement to the §501(c)(4) exemption in any year subsequent to 1990. The uncertainty of the outcome on a novel issue combined with the potential costs to both sides justified meticulous preparation to achieve a strong posture at trial or for negotiating purposes. Thorough preparation is not inexpensive.

Id. at 444.

Similarly, in *Estate of O'Neal v. United States*, 2002 WL 31689447 (N.D. Ala. 2002), the court awarded extraordinary fees based partially on the fact that it was a case of first impression. The court reasoned with regard to the cost-reimbursement issue:

The court finds that the facts of the instant case presented a difficult as well as novel issue. This is evident from the Eleventh

Circuit noting this case presented an *issue of first impression*, as well as the fact that the issue of the deduction to which the estate was entitled has been in litigation for eight years. The court further finds that [the taxpayer's] counsel have expertise in tax litigation beyond that which is found in the vast majority of attorneys within the Birmingham area. Furthermore, the court finds \$250.00 an hour is in line with the prevailing rate in this community for complex legal matters. Both [attorneys] represented to the court that they have Masters of Law (in Taxation). All of these factors combined justify an award of \$250.00 per hour for counsel....

Id. at *6 (emphasis added).

CONCLUSION • Winning *any* case against the IRS or the Tax Division of the U.S. Department of Justice tends to provide tremendous satisfaction to the taxpayer. It often generates considerable good cheer for the taxpayer's attorney, too. This is particularly true in cases of first impression, which, by definition, make new law or change present law. Notwithstanding the positive aspects, these cases may be bittersweet for the taxpayer because of their potentially negative effect on cost reimbursement under section 7430.

As this article demonstrates, the majority of courts addressing tax issues of first impression do not award administrative or litigation costs to the taxpayer. There are, of course, exceptions to this general rule. Courts have been willing to grant cost reimbursement when the government advances a position that is contrary to a clear statute, adverse court decisions, invalid regulations, etc. Moreover, courts have found that attorneys handling cases of first impression merit higher hourly rates and/or additional billable hours.

Thus, like most things in life, the decision of whether to seek reimbursement boils down to a cost/benefit analysis. In terms of cost, pursuing reimbursement, especially in complex cases, can be expensive: legal briefs must be drafted, affidavits must be prepared, hearings might be held. Far-fetched though it may sound, sometimes the fees

incurred in seeking fees far exceed the amount of tax at issue in the first place. *See, e.g., Mearkle v. Commissioner*, 838 F.2d 880, 883 (6th Cir. 1988) (taxpayer sought \$25,000 in cost reimbursement in a case involving a \$149 claim). With respect to benefits, if reimbursement is deemed appropriate, cases of first impression may trigger increased billable hours and rates. On a more personal note, benefits also

include the vindication that the taxpayer feels from defeating the tax authorities not only once (on the merits), but twice (on the fees). Is seeking reimbursement aggressive advocacy or merely pushing your luck? That question can be answered *only* by each taxpayer based on the particular facts and circumstances of the case.

**Practice Checklist For
Seeking Cost Reimbursement In Cases Of First Impression:
Zealous Advocacy or Pushing Your Luck?**

The majority of courts addressing tax issues of first impression do not award administrative or litigation costs to the taxpayer.

- There are, of course, exceptions to this general rule.

___ Is the case based on clear and unequivocal statutory language?

___ Are there other ways of arguing that the government lacked substantial justification?

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