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Using Code Sec. 7430 to Obtain Fees and Resolve Your Taxpayer's Case

By Marcia Pereira and Eric L. Green

Marcia Pereira and Eric L. Green using Code Sec. 7430 to recover litigation costs and resolve your taxpayer's case.

Background

Taxpayers involved in a controversy with the IRS may be able to obtain reimbursement of the fees and expenses they incurred in the controversy if they meet the requirements of Internal Revenue Code (the "Code") Sec. 7430, which states that a taxpayer may recover their litigation costs if the taxpayer meets the following criteria:

- The costs are associated with the determination;
- The costs incurred by the taxpayer are only those associated with the United States and not another third party;
- The taxpayer exhausted their administrative remedies;
- The taxpayer did not protract the proceedings; and
- The taxpayer is the prevailing party.

In attempting to meet Code Sec. 7430 criteria, taxpayers frequently have difficulty demonstrating that they were the prevailing party. In addition, even if the taxpayer is the prevailing party, there are a few exceptions to the general rule, which include a net-worth test and reasonable-basis test.

To avoid the difficulty of meeting the prevailing party test, and to increase pressure on the IRS to seriously consider the taxpayer's position, Code Sec. 7430 allows the taxpayer to make a "qualified offer." By making a qualified offer to the IRS, the practitioner raises the stakes for the government because it puts the issue of obtaining reimbursement for the taxpayer's costs and fees front and center for the government, and helps assure your client's case will be given all due consideration and potentially settle the case.

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Costs Associated with the Determination

If taxpayers meet the foregoing criteria they can recover costs and fees incurred, including, but not limited to, litigation costs and administrative fees provided that they are deemed reasonable. Only costs allocable to the United States will be recoverable.¹ Attorney's fees are limited by Code Sec. 7430(c)(1)(B)(iii) and adjusted for inflation. Currently taxpayers may recover \$180 per hour for attorney's fees in 2011.²

Exhaustion of Administrative Remedies and Unreasonable Delay

The taxpayer must not have unreasonably protracted the proceedings.³ Further, and perhaps one of the most important thresholds, to qualify for recovery of attorneys' fees and costs, the taxpayer must have exhausted all the administrative remedies made available to address the taxpayer's tax liability.⁴ The taxpayer must allow the IRS its opportunity to resolve the matter and be forced into litigating the issue in order to claim their fees. Nevertheless, the taxpayer must be aware of their right to an administrative hearing. The U.S. tax court has held that exhaustion of administrative remedies does not include administrative resources not disclosed to the taxpayer.⁵

In any event, in considering whether to file a claim for attorney's fees and administrative costs, one should confirm that all the administrative paths were explored and respective deadlines were observed.⁶

Taxpayer as the Prevailing Party

As a general rule, the taxpayer may qualify as a prevailing party if the taxpayer has substantially prevailed with respect to the amount in controversy or has substantially prevailed with respect to the most significant issue or set of issues.⁷ There are several exceptions to this rule, including the reasonable-basis test and the net-worth exception.

Reasonable Basis Test

If the IRS's position is not substantially justified with respect to the amount disputed or the most significant issue (or issues) presented, the taxpayer will be considered a prevailing party provided all other Code Sec. 7430 requirements are met.⁸ A substantially justified position is one in which the evidence presented is deemed adequate to support a conclusion, is capable of satisfying reasonable minds and has reasonable basis in fact and law.⁹ Nevertheless, the position may not be unjustifiable or unreasonable merely because the taxpayer wins on appeal or the IRS has conceded, lost the case or a particular issue in controversy.¹⁰ In making its determination as to whether the position is substantially justified, the court will look at the government's grounds for its legal position and its consistency in maintaining it.¹¹ The court will also take judicial notice of prior conflicting decisions on substantially similar issues.¹² A rebuttable presumption of unjustifiable position will arise if the IRS fails to follow its applicable published guidelines.¹³ The taxpayer seeking recovery of litigation costs bears the burden of establishing the government's lack of substantially justified position.¹⁴

Net-Worth Requirements

Once the tax court determines that the taxpayer is the prevailing party under Code Sec. 7430(c)(4)(E), the taxpayer must also meet the net-worth requirements.¹⁵ To satisfy this requirement, if the taxpayer is an individual or estate,¹⁶ the taxpayer's net worth cannot exceed \$2 million (\$4 million if joint). If the taxpayer is a corporation or partnership, its net worth cannot exceed \$7 million and the corporation or partnership must not have more than 500 employees.¹⁷

Settlements and other proceedings. As a caveat, a taxpayer will not qualify as a prevailing party if the court has determined the tax liability, interest, penalty or tax refund claim pursuant exclusively to a settlement,¹⁸ or the proceeding does not put the tax liability at issue such as in declaratory judgment proceeds or in proceedings commenced for purposes of enforcing or quashing summons and any actions under Code Sec. 6110(f).¹⁹

Qualified Offers

In 1998, Congress modified Code Sec. 7430 and allowed the taxpayers to make a qualified offer as a way to set the record for the taxpayer being deemed the

"prevailing party."²⁰ While qualified offers were added to the Code over 10 years ago and it is a great negotiation tool to settle tax cases with the IRS, it remains forgotten in most cases for no clear reason. By making a qualified offer, the taxpayer not only makes a serious offer to resolve the matter, but raises the stakes for the Government for, should it decide not to accept the offer, it risks having to reimburse the taxpayer for the fees and costs incurred. In other words, the taxpayer's submission of a qualified offer will immediately get the IRS's attention and potentially lead to quicker resolution of the taxpayer's case. Nevertheless, this tool remains a little-used option in tax controversies.

The term "qualified offer" is a term of art and is defined as an offer that meets with the following thresholds:

- It is a written offer.
- It is made by the taxpayer to the IRS during the qualified offer period, which is defined as the period that starts on the date of the first letter of proposed deficiency, which allows the taxpayer an opportunity for administrative review with the Appeals Office, and ending on the date which is 30 days before the date the case is first set for trial.²¹
- It clearly specifies the amount offered in lieu of the IRS's proposed liability (for purposes of this requirement, the adequacy of the amount of the offer will be entertained without regard to interest).²²
- It is designated as a "qualified offer" within the meaning of Code Sec. 7430.²³
- It remains open during the period beginning on the date it is made and ending on the earliest of the date the offer is rejected, the date the trial begins or the 90th day after the date the offer is made.²⁴

The "qualified offer rule"²⁵ provides that a taxpayer may recover reasonable attorney's fees and administrative costs incurred to determine tax, interest or penalty or claiming refund under the Code.²⁶

By making a qualified offer, the taxpayer sets the amount that will determine which of the parties prevailed. The taxpayer will be deemed the prevailing party if the taxpayer's last qualified offer commits to a liability that would equal or exceed the amount of the taxpayer's liability as determined by the court without regard as to whether the Commissioner's position is substantially justified.²⁷ The amount of taxpayer's tax liability stated in the court judgment has to be less than or equal to the amount of the last qualified offer, taking into account certain adjustments up to the date of the offer.

Reasonable litigation costs requirement. Once the taxpayers pass the "prevailing party" test, taxpayers still need to satisfy the requirement that the claimed fees be reasonable²⁸ and actually incurred and paid on or after the date of the last qualifying offer.²⁹

Recovery of Awards and Fees in Administrative Proceedings

In addition to recovery of attorney's fees and costs in litigation proceedings, Code Sec. 7430(a)(1) also provides for the recovery of "reasonable administrative costs."³⁰ This recovery is limited to those cases in which the taxpayer has not initiated court proceedings. An "administrative proceeding" is defined as a procedure that does not include:

- "Matters of general application," such as hearings on regulations, comments on forms, or proceedings involving revenue rulings or revenue procedures;
- requests for private letter rulings or "similar" determinations;
- technical advice memoranda submitted prior to the administrative proceeding "date"; and
- certain collections actions.³¹

The taxpayer will not be entitled to an award of administrative costs if the IRS does not issue a Notice of Decision or Notice of Deficiency.³² The Treasury Regulations seem to suggest that costs incurred prior to the issuance of such notices are not recoverable.

The taxpayer must also be the prevailing party of the underlying proceeding and conform to the other requirements of Code Sec. 7430.³³ The taxpayer must also file a written request for recovery at the required location. The request must contain statements, affidavit(s), documents and information supporting the claim for administrative costs.³⁴

Administrative Costs for Violation of Bankruptcy Proceedings³⁵

Lastly, the taxpayer may also be entitled to recover reasonable administrative costs if such costs were incurred in response to IRS's willful violation of the automatic stay or injunction provisions of the Bankruptcy Code.³⁶ In order to be allowed recovery, the taxpayer must be the prevailing party, meet the requirements of Reg. § 301.7430-5 and that the IRS fails the "substantially justified" test.³⁷ Recovery is only allowable to the extent of costs incurred after the date of the filing of the bankruptcy petition.³⁸

Conclusion

A qualified offer is a powerful tool in negotiating with the IRS by increasing the pressure on the government to settle the tax case and should be seriously considered by practitioners whenever they find themselves involved in either litigation or potential litigation with the IRS.

ENDNOTES

¹ Code Sec. 7430(b)(1).

² Rev. Proc. 2010-46, IRB 2010-49, 814.

³ Code Sec. 7430(b)(3). What would constitute "unreasonably protracting the proceedings" is not entirely clear. In *Lipitz Est.*, *infra*, note 27, where the court held that taxpayer had not unreasonably protracted the proceedings by failing to respond to IRS summons where taxpayer was not in a "position to play active role in responding to summons, and taxpayer could not be faulted for failure to comply with 20 year old summons where there was no evidence that she even knew of summons until January 2006." *But see*, *R.R. Mearkle*, 90 TC 1256, Dec. 44,854 (1998), where taxpayer was precluded from recovery of attorney's fees and costs because, among other things, taxpayer was held to have had unreasonably protracted this proceeding by refusing to accept a full concession by respondent four months before trial, and will not be awarded costs for the period in which he protracted the litigation.

⁴ Code Sec. 7430(b)(1).

⁵ A taxpayer who was not informed of the right to an Appeals Conference has exhausted all administrative remedies. *J.H. Swanson*, 106 TC 76, Dec. 51,155 (1996). Also, a taxpayer has exhausted all administrative remedies where he was never afforded an opportunity to meet with an IRS representative. *A.C. Buck*, 65 TCM 1743, Dec. 48,819(M), TC Memo. 1993-16. It appears that the taxpayer does not have to pursue administrative remedies the IRS says to be unnecessary. Reg. § 301.7430-1(e)(1). Practitioners should also be aware of the exceptions to the exhaustion of remedies listed under Reg. § 301.7430-1(f). For example, the exhaustion of administrative remedies rule will be deemed satisfied if the taxpayer did not receive the 30-day letter prior to the statutory notice (known as the "90-day letter") so long as the nonreceipt is not due taxpayer's failure to provide current mailing address or the like. Reg. § 301.7430-1(f)(2)(i).

⁶ The court denied recovery of attorney's fees where a third-party was successful in wrongful levy claim, but failed to file an administrative claim five days prior to the filing of the tax court petition. *R. Moreno-Padilla*, DC-Calif., 95-1 USTC ¶ 50,306, 75 AFTR 2d 95-2694. Taxpayer's decision not to go to Appeals prior to the issuance of a notice of deficiency deemed as a failure to exhaust administrative remedies. *Haas & Assoc. Accountancy Corp.*, 117 TC 48 (2001), *aff'd*, CA-9, 2003-1 USTC ¶ 50,253, 55 FedAppx 476. Further, a taxpayer will not be considered to have "participated" in an Appeals office conference unless the taxpayer discloses all information taxpayer knew or should have known was relevant at the time of the conference. Reg. § 301-7430-1(b)(2). It is not clear what constitutes "all information" for purposes of this rule, however, the tax court has held that taxpayer is not required to seek out every possible piece of relevant information or to postulate every plausible theory in order to exhaust