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1988 Amendment to 26 U.S.C. Section 7430: Expanding Taxpayers' Rights to Recover Costs in Tax Controversies

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RECENT DEVELOPMENT

The 1988 Amendment to 26 U.S.C. Section 7430: Expanding Taxpayers' Rights to Recover Costs in Tax Controversies

I. INTRODUCTION

Bureaucratic mistakes at the Internal Revenue Service (IRS) forced Barbara and David Kaufman to seek a court-ordered injunction prohibiting the IRS from collecting a 14,380 dollar tax assessment for

1980.[1] Even though the Kaufmans had notified the IRS office in Chicago of their new Maine address, the IRS mistakenly mailed the preliminary notice of deficiency to the Kaufmans' prior Illinois address.[2] In addition, the Service mailed the statutory notice of deficiency to another couple also named Barbara and David Kaufman.[3] Because the Kaufmans never received notice of the proposed deficiency, they did not have an opportunity to contest the tax assessment. The Kaufmans first became aware of the deficiency in 1983 when the IRS seized the refund from their 1982 return in partial satisfaction of the deficiency.[4] Shortly thereafter the taxpayers initiated suit for an injunction against further collection efforts. Once apprised of its errors, the IRS agreed to the entry of a permanent injunction.[5] The Kaufmans then sought to recover their attorney's fees and other litigation costs pursuant to 26 U.S.C. section 7430.[6]

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1. Kaufman v. Egger, 758 F.2d 1, 2 (1st Cir. 1985).
2. *Id.* at 2 & n.1.
3. *Id.* at 2 & n.2.
4. *Id.* at 2.
5. *Id.*
6. 26 U.S.C. § 7430 (1982) (in effect until Dec. 31, 1985), *re-enacted and amended by* 26 U.S.C. § 7430 (Supp. V 1987), *amended by* Technical and Miscellaneous Revenue Act of 1988, 26 U.S.C.A. § 7430 (West 1989). The version of § 7430 that was enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982 provided in part:

(a) In general

In the case of any civil proceeding which is—

(1) brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty under this title, and

(2) brought in a court of the United States (including the Tax Court),

the prevailing party may be awarded a judgment for reasonable litigation costs incurred in such proceeding.

. . . .

(c) Definitions

(1) Reasonable litigations costs

(A) In general

The term "reasonable litigation costs" includes—

(i) reasonable court costs,

(ii) the reasonable expenses of expert witnesses in connection with the civil proceeding,

(iii) the reasonable cost of any study, analysis, engineering report, test, or project which is found by the court to be necessary for the preparation of the party's case, and

(iv) reasonable fees paid or incurred for the services of attorneys in connection with the civil proceeding.

(B) Attorney's fees

In the case of any proceeding in the Tax Court, fees for the services of an individual (whether or not an attorney) who is authorized to practice before the Tax Court shall be treated as fees for the services of an attorney.

(2) Prevailing party

(A) In general

The term "prevailing party" means any party to any proceeding described in subsection (a) (other than the United States or any creditor of the taxpayer involved) which—

(i) establishes that the position of the United States in the civil proceeding was unreason-

The original section 7430 permitted a taxpayer to recover reasonable litigation costs if the Government took an unreasonable position in a civil proceeding[7] and if several other requirements were satisfied.[8] Both the original section 7430 and its 1986 re-enactment caused confusion in identifying the relevant time at which the inquiry into the reasonableness of the Government's position should occur.[9] Whether the statute permits the court to consider the Government's prelitigation conduct or only its litigation position may have drastic consequences for the taxpayer. For example, in the Kaufmans' situation, if only the Government's litigation position were considered, the taxpayers would be unable to recover litigation costs because the Government took the reasonable position of agreeing to the entry of an injunction. If, however, the appropriate inquiry extends to prelitigation conduct, then the Government's seizure of funds pursuant to a statutory notice of deficiency that the taxpayers never received improves the Kaufmans' chances of recovering litigation costs because the Government's action prior to the initiation of litigation appears unreasonable.

Under the original section 7430, the circuit courts of appeals disagreed on the appropriate interpretation of the language in the statute that allowed courts to consider the "position of the United States in a civil proceeding." Some courts read the statute broadly to include the administrative, or prelitigation, conduct of the IRS in a tax dispute.[10] Other courts read the statute more narrowly and considered only the litigation position of the United States.[11] Despite the 1986 re-enact-

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able, and

(ii)(I) has substantially prevailed with respect to the amount in controversy, or

(II) has substantially prevailed with respect to most significant issue or set of issues presented.

Id.

7. *Id.* § 7430(c)(2)(A)(i).

8. The most important requirements included exhaustion of administrative remedies, *id.* § 7430(b)(2), prevailing substantially with respect to the amount in controversy or prevailing substantially with respect to the most significant issue or set of issues presented, *id.* § 7430(c)(2)(A)(ii)(I), (II), and limitation to reasonable costs, *id.* § 7430(c)(1).

9. The original § 7430 contained a sunset date of December 31, 1985. *Id.* § 7430(f). As part of the Tax Reform Act of 1986, Congress re-enacted § 7430 with modifications. *Id.* § 7430 (Supp. V 1987) (*re-enacting and amending* 26 U.S.C. § 7430 (1982)).

10. *See* Comer v. Commissioner, 856 F.2d 775, 780 (6th Cir. 1988) (holding that the "inquiry extends to the reasonableness of the behavior that forced the taxpayer to incur the expenses related to the filing of a petition"); Sliwa v. Commissioner, 839 F.2d 602, 607 (9th Cir. 1988) (stating that if the statute is to have any effect, courts must be permitted to examine the Government's prelitigation conduct); Powell v. Commissioner, 791 F.2d 385, 392 (5th Cir. 1986) (holding that the focus of the reasonableness inquiry is the IRS's position at the time the taxpayer filed a petition); Kaufman v. Egger, 758 F.2d 1, 4 (1st Cir. 1985) (stating that IRS liability will be triggered by unreasonable conduct regardless of the stage in the proceedings); *see also infra* notes 105-27 and accompanying text.

11. *See* Wickert v. Commissioner, 842 F.2d 1005, 1008 (8th Cir. 1988); Ewing & Thomas, P.A.

ment's apparent clarification of the issue, disagreement among the circuits persisted.[12]

This Recent Development explores the 1988 amendment to section 7430. The amendment clarifies existing law by explicitly adopting an inquiry into the reasonableness of the Government's actions during the prelitigation stage. Part II describes briefly the general procedure in tax disputes and evaluates the history of awards for legal fees and litigation costs in tax cases prior to the 1988 amendment. Part III analyzes the scope of the 1988 amendment, and Part IV examines the amendment's effect on existing law and policy. Part V concludes that the Senate's definition of the position of the United States would better fulfill the purposes of section 7430.

II. LEGAL BACKGROUND

A. *Procedure in Tax Cases*

Because the prior controversy concerning the proper time at which the Government's position is established revolves around the Government's administrative as opposed to litigation position, a brief summary of the prelitigation procedure followed in tax cases is necessary. The discussion that follows concerns tax procedure in general and does not purport to be exhaustive.

Tax disputes commence when the IRS notifies a taxpayer of an impending audit and, in some cases, informs the taxpayer of the issues that will be examined by the revenue agent.[13] The taxpayer may provide information and legal arguments for items that the agent questions.[14] If the taxpayer and the revenue agent agree to proposed

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v. Heye, 803 F.2d 613, 615 (11th Cir. 1986) (stating that the reasonableness inquiry extends to the Government's in-court litigating position); Baker v. Commissioner, 787 F.2d 637, 641 (D.C. Cir. 1986) (finding that the "relevant position of the United States is the one taken in the civil proceeding"); United States v. Balanced Fin. Management, Inc., 769 F.2d 1440, 1450 (10th Cir. 1985) (concluding that "the position of the United States means the arguments relied upon by the Government in litigation"); *see also infra* notes 59-104 and accompanying text.

12. *Compare* Weiss v. Commissioner, 850 F.2d 111, 115 (2d Cir. 1988) (concluding that the Government's position may be established before the District Counsel becomes involved in the case if the Government takes a position that leaves the taxpayer no other choice than a judicial remedy) *with* Sher v. Commissioner, 861 F.2d 131, 133 (5th Cir. 1988) (holding that the Government's position was established only after the District Counsel became involved in the case). For a discussion of *Weiss* and *Sher*, see *infra* notes 139-66 and accompanying text.

13. *See* I. SHAFIROFF, INTERNAL REVENUE SERVICE PRACTICE AND PROCEDURE DESKBOOK 35 (1985).

14. *See* M. GARBIS, P. JUNGHANS & S. STRUNTZ, FEDERAL TAX LITIGATION: CIVIL PRACTICE AND PROCEDURE 1-10 to -11 (1985). An office examination occurs at the district director's office. *Id.* at 1-8. Advance notice of the issues permits the taxpayer or his representative to gather proof and relevant legal arguments to support the items on his return prior to the examination. *Id.* at 1-10. By contrast, a field examination occurs at the taxpayer's place of business, *id.* at 1-8, and the taxpayer typically does not know which items the agent disputes until the examination is com-

adjustments, the revenue agent describes the tentative settlement in his report. The settlement is finalized once the Quality Review Staff of the IRS accepts the report.[15] If, however, the revenue agent and the taxpayer do not reach an agreement, the agent issues a report summarizing the taxpayer's proof and legal arguments, the proposed settlement, the reasons for rejecting the settlement, and the agent's opinion of the case.[16] After this report, the case usually is forwarded for review, and the District Director of the IRS issues a thirty-day letter.[17]

The thirty-day letter proposes adjustments to the taxpayer's return and informs the taxpayer of the available administrative appeal options.[18] First, the taxpayer may choose to obtain administrative relief by filing a protest with the IRS Appeals Office within thirty days and requesting a conference.[19] This alternative benefits the government and the taxpayer because it saves time and money that otherwise would be spent in litigation.[20] Alternatively, the taxpayer may choose to ignore the thirty-day letter and, after receiving a statutory notice of deficiency, also known as a ninety-day letter, file a petition in the United States Tax Court disputing the Government's claim.[21] Third, the taxpayer may choose to pay the tax and file a refund claim.[22] If the claim is rejected or if six months have passed since the date of filing, the taxpayer may initiate a refund suit in a United States district court or the United States Claims Court.[23]

Taxpayers who choose to seek relief from the Appeals Office through a conference must explain in their protest the reasons for contesting the revenue agent's findings.[24] The Appeals Office performs an independent review of the revenue agent's report, the taxpayer's pro-

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pleted, *id.* at 1-10. A second conference often is scheduled, and the taxpayer or a representative then presents the documents and legal authority supporting the taxpayer's position. *Id.* at 1-11.

15. *Id.* at 1-20.

16. *Id.* at 1-19.

17. M. SALTZMAN, IRS PRACTICE & PROCEDURE 8-70 to -71 (1981).

18. M. SALTZMAN, *supra* note 17, at 8-70.

19. M. GARBIS, P. JUNGHANS & S. STRUNTZ, *supra* note 14, at 1-22.

20. M. SALTZMAN, *supra* note 17, at 9-2.

21. *See id.* at 8-70.

22. *Id.*

23. *See* M. GARBIS, P. JUNGHANS & S. STRUNTZ, *supra* note 14, at 15-47; *see also* 28 U.S.C. § 1346(a)(1) (1982). Section 1346(a)(1) states:

> (a) The district courts shall have original jurisdiction, concurrent with the United States Claims Court, of:
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> (1) Any civil action against the United States for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed or collected, or any penalty claimed to have been collected without authority or any sum alleged to have been excessive or in any manner wrongfully collected under the internal-revenue laws.

Id.

24. M. GARBIS, P. JUNGHANS & S. STRUNTZ, *supra* note 14, at 1-26.

test, and any other evidence that the taxpayer submits.[25] The Appeals Officer may consider evidence that is inadmissible in court because the Appeals Office is not bound by the Federal Rules of Evidence.[26]

If the taxpayer cannot reach an agreement at the Appeals Office, the IRS issues a statutory notice of deficiency giving the taxpayer ninety days[27] to file a petition in Tax Court.[28] The taxpayer initiates litigation by filing this petition. If the taxpayer fails to file within the requisite time period, the deficiency may be assessed and collected.[29]

If the taxpayer does not choose to respond to the thirty-day letter by requesting an Appeals Office conference and does not pay the tax, the IRS will issue a ninety-day letter.[30] Once the taxpayer responds to this letter by filing a Tax Court petition and the case is docketed, the taxpayer still may be referred to the Appeals Office for settlement before trial.[31] Thus, cases reach the Appeals Office in two ways: as undocketed cases at the administrative level, or as docketed cases referred for settlement after the taxpayer has filed a Tax Court petition.

B. Equal Access to Justice Act

The American rule concerning payment of court costs requires each party to pay its own expenses.[32] In addition, a private party cannot sue the United States Government unless Congress explicitly waives sovereign immunity.[33] In 1980 Congress passed the Equal Access to Justice Act (EAJA),[34] section 7430's predecessor, which provided for a broad waiver of sovereign immunity[35] and for the shifting of litigation costs to

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25. *Id.* at 1-27 to -28.

26. *See* I. SHAFIROFF, *supra* note 13, at 59.

27. Three exceptions to the 90-day time limit exist: 26 U.S.C. § 6851 (1982) (for taxpayers suspected of acting in a manner that will hinder collection of the tax; for example, leaving the country or concealing property); *id.* § 6852 (for organizations that have made flagrant violations of the prohibition against political expenditures); and *id.* § 6861 (for taxes the Secretary believes will be jeopardized by delay).

28. *See* M. SALTZMAN, *supra* note 17, at 9-8.

29. *See* M. GARBIS, P. JUNGHANS & S. STRUNTZ, *supra* note 14, at 1-24.

30. *See id.*

31. *See* I. SHAFIROFF, *supra* note 13, at 54.

32. *See* Alyeska Pipeline Serv. Co. v. Wilderness Soc'y, 421 U.S. 240, 247 (1975).

33. *See* Feres v. United States, 340 U.S. 135, 139 (1950) (stating that "[w]hile the political theory that the King could do no wrong was repudiated in America, a legal doctrine derived from it that the Crown is immune from any suit to which it has not consented was invoked on behalf of the Republic and applied by our courts as vigorously as it had been on behalf of the Crown").

34. *See* Equal Access to Justice Act, Pub. L. No. 96-481, 94 Stat. 2325 (1980) (codified in scattered sections of the United States Code, including titles 5, 28, and 48).

35. 28 U.S.C. § 2412(d)(1)(A) (1982), *repealed by* Pub. L. No. 96-481, tit. II, § 204(c), 94 Stat. 2329 (1980) (effective Oct. 1, 1984), *re-enacted and amended by* 28 U.S.C. § 2412(d)(1)(A) (Supp. V 1987), stated:

> Except as otherwise specifically provided by statute, a court shall award to a prevailing party other than the United States fees and other expenses, in addition to any costs awarded

the United States[36] under certain circumstances. The purposes of the Act were (1) to encourage suits by those who might be deterred from seeking relief from arbitrary government action due to the expense involved and (2) to promote accountability for government agencies' actions.[37]

The EAJA specified that the Government would be required to pay a prevailing party's litigation costs unless the position of the United States was substantially justified or unless such payment would be unjust.[38] The Act placed the burden of proof on the Government to show that an award was inappropriate.[39] Tax Court litigants, however, were excluded from the EAJA because it only applied to article III courts.[40]

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pursuant to subsection (a), incurred by that party in any civil action (other than cases sounding in tort) brought by or against the United States in any court having jurisdiction of that action, unless the court finds that the position of the United States was substantially justified or that special circumstances make an award unjust.

Id. Similarly, 5 U.S.C. § 504(a)(1) (1982), *repealed by* Pub. L. No. 96-481, tit. II, § 203(c), 94 Stat. 2327 (1980) (effective Oct. 1, 1984), *re-enacted and amended by* 5 U.S.C. § 504(a)(1) (Supp. V 1987) stated:

An agency that conducts an adversary adjudication shall award, to a prevailing party other than the United States, fees and other expenses incurred by that party in connection with that proceeding, unless the adjudicative officer of the agency finds that the position of the agency as a party to the proceeding was substantially justified or that special circumstances make an award unjust.

Id. This waiver of sovereign immunity "reflects the belief that, at a minimum, the United States should be held to the same standards in litigating as private parties." H.R. REP. No. 1418, 96th Cong., 2d Sess. 9, *reprinted in* 1980 U.S. CODE CONG. & ADMIN. NEWS 4984, 4987.

36. 28 U.S.C. § 2412(d)(1)(A) (1982); *see also* H.R. REP. No. 1418, *supra* note 35, at 9, *reprinted in* 1980 U.S. CODE CONG. & ADMIN. NEWS at 4988 (noting that although one purpose of the American rule is not to deter litigation, the rule frequently has the opposite effect when the Government is a party to the litigation).

37. H.R. REP. No. 1418, *supra* note 35, at 6, *reprinted in* 1980 U.S. CODE CONG. & ADMIN. NEWS at 4984 (referring to the removal of economic deterrents); *see also Award of Attorney's Fees in Tax Cases, Hearings Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means*, 99th Cong., 1st Sess. 32 (1985) [hereinafter *Attorney's Fees Hearings*] (remarks of Glenn L. Archer, Jr., Assistant Att'y Gen., Tax Div., Dep't of Justice) (referring to government accountability).

38. 28 U.S.C. § 2412(d)(1)(A) (1982); *see also* H.R. REP. No. 1418, *supra* note 35, at 10, *reprinted in* 1980 U.S. CODE CONG. & ADMIN. NEWS at 4989. The Report stated that "[t]he test of whether or not a Government action is substantially justified is essentially one of reasonableness. Where the Government can show that its case had a reasonable basis both in law and fact, no award will be made." *Id.*

39. 28 U.S.C. § 2412(d)(1)(A) (1982); *see* Williamson v. United States, 573 F. Supp. 11, 11 (N.D. Ga. 1983) (noting that the Government has the burden of proof under the EAJA); *see also* H.R. REP. No. 1418, *supra* note 35, at 11, *reprinted in* 1980 U.S. CODE CONG. & ADMIN. NEWS at 4989 (concluding that "it is far easier for the Government, which has control of the evidence, to prove tbe reasonableness of its action than it is for a private party to marshal the facts to prove that the Government was unreasonable"). The definition of party excluded individuals and business entities having high net worths. 28 U.S.C. § 2412(d)(2)(B) (1982).

40. McQuiston v. Commissioner, 78 T.C. 807, 810-11 (1982) (citing 28 U.S.C. § 451 (1982)), *aff'd*, 711 F.2d 1064 (9th Cir. 1983).

Because a significant number of cases were brought in Tax Court,[41] and because the Treasury Department lobbied for separate treatment of tax cases,[42] Congress enacted 26 U.S.C. section 7430 to supplant the EAJA for tax litigation.

C. *The Original 26 U.S.C. Section 7430*

The Treasury Department opposed the inclusion of tax cases in the EAJA because it felt that the Act would encourage excessive litigation and thus interfere with the collection of revenue.[43] In seeking separate treatment of tax cases, the Treasury Department first contended that suits for litigation costs would aggravate the Tax Court's already heavy caseload.[44] Second, the Treasury Department contended that the possibility of recovering litigation expenses would encourage taxpayers to litigate rather than settle during the IRS administrative appeals process.[45] Third, since tax cases are often complex and result in no obvious winner, the Treasury Department argued that the EAJA's prevailing party requirement was inappropriate for tax litigation.[46]

In response to these objections from the Treasury Department, Congress enacted 26 U.S.C. section 7430, a fee-shifting statute specifically tailored to tax litigation.[47] The purpose of section 7430 is the same as the EAJA: encouraging litigants to seek relief from abusive government action.[48] Nevertheless, the statutes contain significant differences. First, a taxpayer suing for costs under section 7430 bears the burden of proving that the Government's position was unreasonable.[49] Under the EAJA, the Government has this burden of proof. Second, the definition of a prevailing party is more stringent under section 7430. Under section 7430 a party must prevail substantially on the amount in contro-

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41. *See Attorney's Fees Hearings*, *supra* note 37, at 62 (remarks of James B. Lewis, Chairman of the American Bar Association, Taxation Section) (stating that "[a]pproximately 90 percent of all federal civil tax proceedings are in the Tax Court").

42. *Id.* at 50-51 (remarks of Louise L. Hill, Assistant Prof. of Law, Univ. of Toledo College of Law).

43. *Id.* at 51.

44. *Id.*

45. *Id.*

46. *Id.* (stating that "since tax cases often involve many unrelated issues of fact and several taxable years, there is often no clear-cut winner").

47. 26 U.S.C. § 7430 (1982). The Commissioner of the IRS noted that "[w]hen Congress enacted section 7430 it did not adopt the definitions in the standards of the Equal Access to Justice Act and apply them to tax cases. Instead, Congress created a new set of definitions and standards intended to apply exclusively to tax cases." *Attorney's Fees Hearings*, *supra* note 37, at 13 (remarks of the Honorable Roscoe L. Egger, Jr., Commissioner of Internal Revenue).

48. *See* H.R. REP. No. 404, 97th Cong., 2d Sess. 11 (1982) (stating that § 7430 is designed to "deter abusive actions and overreaching by the Internal Revenue Service and [to] enable individual taxpayers to vindicate their rights regardless of their economic circumstances").

49. 26 U.S.C. § 7430(c)(2)(A)(i) (1982).

versy or prevail substantially concerning the most significant issue or set of issues in the case,[50] but under the EAJA a party must succeed only on any significant issue.[51] Third, section 7430, unlike the EAJA, requires exhaustion of administrative remedies before a taxpayer can seek relief.[52] Fourth, section 7430 imposes a 25,000 dollar cap on attorney's fees[53] while the EAJA only limits the hourly rate.[54]

The circuit courts of appeals disagreed over the appropriate time at which a court must assess the reasonableness of the Government's position in a suit for costs under section 7430.[55] The statute defines a prevailing party as one who "establishes that the position of the United States in the civil proceeding was unreasonable."[56] Some courts have interpreted civil proceeding to mean the Government's in-court litigating position.[57] Other courts, however, have taken a broader approach and considered the Government's prelitigation or administrative position.[58]

1. Litigation Position

In *United States v. Balanced Financial Management, Inc.*[59] the Tenth Circuit defined the position of the United States restrictively. When the taxpayers in *Balanced* refused to obey a summons and court order requiring them to produce documents for the IRS, the Government instituted a contempt proceeding against the taxpayers.[60] Despite adequate notice concerning the time of the hearing,[61] the Government's attorney failed to appear.[62] The district court deemed the Government's improper prosecution unreasonable and awarded the taxpayers over 12,000 dollars in attorney's fees.[63] In reversing this award, the Tenth Circuit relied on another Tenth Circuit EAJA case that measured the position of the United States by the Government's arguments presented during litigation.[64] Because the taxpayers had failed to obey the district

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50. *Id.* § 7430(c)(2)(A)(ii)(I), (II).
51. *See Attorney's Fees Hearings*, *supra* note 37, at 46 (remarks of Louise L. Hill, Assistant Prof. of Law, Univ. of Toledo College of Law).
52. 26 U.S.C. § 7430(b)(2) (1982).
53. *Id.* § 7430(b)(1).
54. 28 U.S.C. § 2412(d)(2)(A)(ii) (1982).
55. *Cf. supra* notes 10, 11, and accompanying text.
56. 26 U.S.C § 7430(c)(2)(A)(i) (1982).
57. *See supra* note 11.
58. *See supra* note 10.
59. 769 F.2d 1440 (10th Cir. 1985).
60. *Id.* at 1442-43.
61. *Id.* at 1450 n.11.
62. *Id.* at 1443.
63. *Id.*
64. *Id.* at 1450 (citing United States v. 2116 Boxes of Boned Beef, 726 F.2d 1481, 1487 (10th

court's order requiring them to comply with the Government's summons, the Tenth Circuit concluded that the Government's position in the underlying contempt proceeding was not unreasonable, and the failure of the Government's attorney to appear at the contempt hearing did not change this result.[65]

In *Baker v. Commissioner*[66] the District of Columbia Circuit reached a similar conclusion. The court in *Baker* also relied on the EAJA to determine that 26 U.S.C. section 7430 encompassed only the Government's litigation position.[67] The taxpayer in *Baker* worked for a hospital in Saudi Arabia and was required to live in an apartment provided by the hospital.[68] In computing his federal income tax, the taxpayer excluded the value of his living accommodations from gross income. The taxpayer relied on a statutory exclusion pertaining to employer-provided housing for United States citizens living abroad.[69] Because the exclusion of the taxpayer's particular accommodations violated a Treasury regulation that limited the scope of the exclusion,[70] however, the IRS denied the exclusion and issued a statutory notice of deficiency.[71]

The taxpayer filed a *pro se* petition in Tax Court and tried to resolve the matter with the IRS office in Cleveland.[72] The taxpayer explained to an appeals officer that two of his coworkers in Saudi Arabia had been denied the lodging exclusion, but that in both instances the Washington, D.C. Appeals Office dismissed the actions.[73] The Washington office allowed the exclusion to the taxpayer's coworkers after the office received letters from the hospital's Personnel and Administrative Services offices.[74] In a letter to the Cleveland Appeals Office, the taxpayer enclosed letters from the same hospital officials and also provided

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Cir.), *cert. denied*, 469 U.S. 825 (1984)).

65. *Balanced Fin. Management*, 769 F.2d at 1450-51.

66. 787 F.2d 637 (D.C. Cir. 1986).

67. *Id.* at 643.

68. *Id.* at 639. Under the hospital's rules and Saudi Arabian custom, the taxpayer and his coworkers were not permitted to live elsewhere. *Id.*

69. The exclusion applied to "lodging provided by the employer for the convenience of the employer 'furnished in a common area (or enclave) which is not available to the public and which normally accommodates 10 or more employees.'" *Id.* (citations to the Internal Revenue Code omitted).

70. The Treasury regulation stated that "a cluster of housing units is not a common area or enclave if it is adjacent to or surrounded by substantially similar housing available to the general public." *Id.* (citing Treas. Reg. § 1.911-1(c)(1), T.D. 7736, 1981-1 C.B. 412, 414). Because the taxpayer's employer-provided housing was surrounded by housing open to the general public, the IRS denied the exclusion even though the taxpayer was not permitted to live elsewhere. *Id.*

71. *Baker*, 787 F.2d at 639.

72. *Id.*

73. *Id.*

74. *Id.* at 640.

the names of the Washington officers who initiated the dismissal of the the coworkers' cases.[75] No evidence indicated that anyone from the Cleveland Appeals Office had called the Washington Office to verify the concessions to the taxpayer's coworkers.[76] When the Cleveland counsel for the Commissioner became involved in the case, he requested more information to support the exclusion.[77] After the taxpayer provided the additional material, the Government conceded the case.[78]

In his suit for attorney's fees the taxpayer alleged that the Government's prelitigation conduct was unreasonable because the IRS had issued a notice of deficiency based on a Treasury regulation that unjustifiably restricted the scope of a statutory exclusion in the Internal Revenue Code.[79] The taxpayer also alleged that the Government's litigation conduct was arbitrary in failing to dismiss the case quickly once the taxpayer proved that the IRS had permitted the exclusion to the taxpayer's similarly situated coworkers.[80]

The District of Columbia Circuit refused to consider the taxpayer's allegation that the Government's prelitigation conduct was unreasonable, holding that the reasonableness of the Government's position must be assessed during litigation.[81] The court compared the language of the EAJA and section 7430 and noted that the EAJA referred only to "the position of the United States," but section 7430 referred to "the position of the United States in a civil proceeding."[82] The court concluded that the modifying phrase, "in a civil proceeding," indicated a congressional intent to restrict the assessment of reasonableness in section 7430 cases to the Government's litigation position.[83] Because the taxpayer's second allegation concerned unreasonable conduct that occurred after the taxpayer filed suit, the court examined this conduct.[84]

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75. *Id.*

76. *Id.*

77. *Id.* The government attorney requested "a map of greater Riyadh, a copy of Baker's employment contract, a narrative description of the taxpayer's living quarters . . . and narrative descriptions of both the Sahara Towers [where taxpayer resided] and the surrounding area." *Id.*

78. *Id.* at 640.

79. *Id.* at 641.

80. *Id.*

81. *Id.*

82. *Id.* at 641 n.8.

83. *Id.*

84. The court remanded the case to the lower court to determine whether the delay in conceding the taxpayer's case was arbitrary. *Id.* at 642-44. The court concluded that on remand the lower court would have to explore several issues:

> Had it become IRS policy to concede the 911 camp exclusion to persons who had no choice to live outside the housing compound or complex to which their employer assigned them? Was it reasonable to insist on documentation from Baker beyond verification that he lived in such housing? Did the IRS routinely concede exclusions on the basis of the documentation Baker originally provided?

In *Ewing and Thomas, P.A. v. Heye*[85] the Eleventh Circuit reached a similar conclusion that courts could consider only the Government's in-court litigation position in awarding fees pursuant to section 7430.[86] The taxpayer in *Ewing* had satisfied a federal tax lien that had been levied on his property. Although the Internal Revenue Code required release of the lien within thirty days of payment,[87] the taxpayer was unable to obtain release of the lien through the administrative process.[88] As soon as the taxpayer filed suit, the Government's attorney started proceedings for the release.[89] Because the Government was possibly unreasonable in the administrative phase but cooperated during litigation, the timing of the reasonableness inquiry was crucial to the taxpayer's success in a section 7430 suit.

The Eleventh Circuit rejected the argument that an EAJA amendment that permitted examination of the Government's administrative conduct should be applicable in interpreting section 7430.[90] The court noted that the legislature, not the judiciary, was responsible for amending statutes and refused to consider administrative conduct.[91]

The last circuit to adopt a restrictive reading of section 7430 relied on a different rationale. Rather than comparing section 7430 with the EAJA, the Eighth Circuit in *Wickert v. Commissioner*[92] considered the re-enacted section 7430 for aid in interpreting the original statute.[93] The taxpayer in *Wickert* contested the Government's determination of a deficiency because she alleged that divorce payments she received from her ex-husband were a property settlement that could be excluded

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Id. at 644.

85. 803 F.2d 613 (11th Cir. 1986).

86. *Id.* at 615.

87. 26 U.S.C. § 6325(a)(1) (1982).

88. *Ewing & Thomas*, 803 F.2d at 614.

89. *Id.*

90. *Id.* at 615-16. The court in Powell v. Commissioner, 791 F.2d 385 (5th Cir. 1986), accepted this argument. *See infra* notes 121-24 and accompanying text.

In 1985 Congress re-enacted and amended the EAJA. The following change clarified the confusion that existed concerning the time at which the position of the United States was identified: "[P]osition of the United States means, in addition to the position taken by the United States in the civil action, the action or failure to act by the agency upon which the civil action is based." 28 U.S.C. § 2412(d)(2)(D) (Supp. V 1987). One commentator has noted that "[t]he purported effect of the above change[] is to clarify the Congressional intent that 'position of the United States' is broader than the government's position as a party in the litigation." Hill, *An Analysis and Explanation of the Equal Access to Justice Act*, 19 ARIZ. ST. L.J. 229, 239 (1987). For an additional discussion of the EAJA amendments, see Winold, *Institutionalizing an Experiment: The Extension of the Equal Access to Justice Act—Questions Resolved, Questions Remaining*, 14 FLA. ST. U.L. REV. 925 (1987).

91. *Ewing & Thomas*, 803 F.2d at 616.

92. 842 F.2d 1005 (8th Cir. 1988).

93. *Id.* at 1008. Congress re-enacted § 7430 in 1986. For a discussion of the provisions of the re-enactment, see *infra* notes 134-38 and accompanying text.

from gross income.[94] This characterization of the payments was inconsistent with the taxpayer's former husband's return in which he identified the payments as deductible alimony.[95] To remedy the inconsistency, the IRS sent statutory notices of deficiency to both the taxpayer and her ex-husband.[96] When it became apparent that Mr. Wickert did not intend to contest his deficiency, the IRS conceded the case to the taxpayer, Mrs. Wickert.[97] While the case was pending, however, the IRS sent the taxpayer several collection notices.[98]

In her section 7430 suit, the taxpayer alleged that the Government acted unreasonably by issuing the notice of deficiency. She claimed that the payments were obviously a property settlement and therefore properly excludable.[99] The taxpayer also claimed that the continued collection efforts were unreasonable.[100] In determining the appropriate time to assess reasonableness, the Eighth Circuit examined the 1986 re-enactment of section 7430. Because the 1986 statute provided expressly for scrutiny of government action at the administrative level and because the statute was prospective, the court reasoned that the re-enactment was meant to modify rather than clarify existing law.[101] Based on this rationale the Eighth Circuit concluded that the original section 7430 applied only to litigation conduct.[102] Once litigation commenced, the court noted that the IRS took the reasonable position of conceding the case.[103] The court refused to examine the reasonableness of the deficiency notice or the continued collection efforts because the court determined that these were actions at the administrative level and therefore barred from consideration.[104]

2. Prelitigation Position

The First Circuit, which initially decided the timing of the reasonableness inquiry under section 7430, took an expansive view, finding that inquiry was appropriate regardless of the stage of the proceeding.[105] *Kaufman v. Egger*[106] involved a bureaucratic mix-up in which the Gov-

94. *Wickert*, 842 F.2d at 1006.
95. *Id.*
96. *Id.*
97. *Id.*
98. *Id.* at 1007.
99. *Id.*
100. *Id.* at 1008.
101. *Id.*
102. *Id.*
103. *Id.*
104. *Id.*
105. Kaufman v. Egger, 758 F.2d 1 (1st Cir. 1985).
106. *Id.*

ernment sent both the proposed and statutory notices of deficiency to the wrong address.[107] Even though the taxpayers never received notice of an alleged 1978 tax deficiency, the Government seized their 1982 refund in partial satisfaction of the deficiency.[108] The taxpayers then brought suit seeking to enjoin future collection efforts.[109] Soon thereafter, the Government agreed to an injunction.[110] Relying on the legislative history of section 7430, the First Circuit concluded that it could assess the reasonableness of the Government's action at any stage in the proceeding.[111] The court cited a committee report which indicated that awards were appropriate "when the United States has acted unreasonably *in pursuing the case.*"[112] The court interpreted this language to mean that prelitigation conduct was within the reasonableness inquiry.[113] Furthermore, the court reasoned that the purpose of the Act would be frustrated if the IRS could escape attorney's fee liability by merely changing its conduct following the taxpayer's initiation of a suit even if the IRS had treated the taxpayer unreasonably at the administrative level.[114] The First Circuit concluded that the IRS's action was unreasonable under any standard and affirmed the award of litigation costs to the taxpayers.[115]

In *Powell v. Commissioner*[116] the Fifth Circuit also found the Government's prelitigation conduct relevant to the reasonableness inquiry. The court, however, retreated from the broad holding in *Kaufman* by finding that only government action at the highest administrative level,

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107. *Id.* at 2.

108. *Id.*

109. *Id.*

110. *Id.*

111. *Id.* at 4.

112. *Id.* (citing Staff of Senate Committee on Finance, Technical Explanation of Committee Amendment, 127 CONG. REC. 15,587, 15,594 (daily ed. Dec. 16, 1981) (emphasis added)).

113. *Kaufman*, 758 F.2d at 4.

114. *Id.*

115. *Id.*

116. 791 F.2d 385 (5th Cir. 1986). The taxpayers in *Powell* deducted 1976 limited partnership losses, represented primarily by a nonrecourse note. The IRS disallowed the deduction and issued a statutory notice of deficiency for 1976. *Id.* at 386. The IRS also issued a statutory notice of deficiency for 1977 in case the taxpayers successfully challenged the disallowance of deductions for 1976. *Id.* at 387. The IRS argued that if a court found that the note, which had been the basis of the partnership losses, did have economic substance, then the note was forgiven and the taxpayers realized income. Thus, this alternative argument was inconsistent with the IRS's first position, which had denied tax effect to the note. *Id.* In the taxpayers' suit for litigation costs for the 1977 action, the taxpayer alleged three instances of unreasonable IRS conduct. First, the 1977 notice of deficiency disallowed deductions that the taxpayer had not taken. Second, the IRS failed to respond to the taxpayers' request for a conference. Third, the 1977 notice forced the taxpayers to initiate litigation in Tax Court. *Id.* Because the Tax Court found in part that only litigation conduct could be considered, it dismissed the taxpayers' action, holding that the allegations concerned prelitigation conduct. *Id.*

rather than all administrative action, could be considered.[117]

Because the statute did not define civil proceeding, the Fifth Circuit tried to interpret the term. The Government noted that other sections of the statute referred to civil proceeding in the context of litigation. For instance, section 7430(a) states that the statute applies to "any civil proceeding which is brought in a *court* of the United States," and sections 7430(c)(1)(A)(ii) and (iv) refer to "reasonable *litigation* costs" incurred in the civil proceeding.[118] In addition, a comparison between the language of the effective date provision and the Conference Committee Report discussing that provision indicated that Congress equated the phrase "civil actions or proceedings" with "civil tax *litigation.*"[119] Because these references associated civil proceedings and litigation, the Government argued that the reasonableness inquiry should extend only to the Government's litigation position. The Fifth Circuit agreed that the Government's interpretation was reasonable, but rejected it in light of Congress's retroactive interpretation of the EAJA.[120]

The Fifth Circuit noted the similarity in language between the EAJA's reference to "civil action" and section 7430's reference to "civil proceeding."[121] The court reasoned that Congress's retroactive interpretation of the EAJA to include prelitigation conduct was equally applicable to section 7430 because taxpayer litigants were already disadvantaged compared to other civil litigants due to significant differences between the EAJA and section 7430.[122] The court found no reason to disadvantage taxpayer litigants further by narrowly interpreting the phrase "position of the United States in the civil proceeding."[123] The court concluded that restricting the relevant prelitigation conduct to government action at the highest administrative level was consistent with the EAJA amendment that defined the position of the United States as the "action or failure to act by the agency upon which the civil action is based."[124] Finally, the Fifth Circuit noted that even the circuits which decided that only the Government's litigation position was relevant to the reasonableness inquiry had reinforced their inter-

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117. *Id.* at 391-92.

118. *Id.* at 388-89 (emphasis added).

119. *Id.* at 389 (emphasis added).

120. *Id.* at 388-89. In 1985 Congress amended the EAJA's definition of position of the United States to include "in addition to the position taken by the United States in the civil action, the action or failure to act hy the agency upon which the civil action is based." 28 U.S.C. § 2412(d)(2)(D) (Supp. V 1987), *amending* 28 U.S.C. § 2412 (1982). The *Ewing* court rejected this argument. *See supra* notes 90, 91, and accompanying text.

121. *Powell*, 791 F.2d at 390.

122. *Id.*; *see also supra* notes 49-54 and accompanying text.

123. *Powell*, 791 F.2d at 390.

124. *Id.* at 391 (citing the amended EAJA).

pretations by looking at the Government's actions immediately prior to the suit.[125]

The dissent in *Powell* objected to the majority's approach to statutory construction[126] and contended that Congress's amendment to the EAJA did nothing to change section 7430. Given the differences between the EAJA and section 7430 that disadvantage taxpayer litigants in comparison to other civil litigants, the dissent argued that interpreting section 7430 narrowly to include only the Government's litigation conduct was more consistent with congressional intent.[127]

D. 1986 Re-enactment of 26 U.S.C. Section 7430

To enable Congress to assess the feasibility of section 7430, the original statute contained a sunset provision that made section 7430 inapplicable to actions commenced after December 31, 1985.[128] Congress re-enacted and modified section 7430 as part of the Tax Reform Act of 1986.[129]

The House bill proposed a four-year extension of the statute,[130] and the Senate proposed modifications that would more closely conform section 7430 with the EAJA. For instance, the Senate suggested that the Government should have the burden of proving that its position was not substantially justified.[131] Also, in order to resolve the circuit split regarding the period when the Government's position should be identified, the Senate recommended that the Government's prelitigation action or inaction should be taken into account.[132] The Senate also suggested that the 25,000 dollar cap on attorney's fees should be replaced with a 75 dollar per hour limitation unless a court found that a higher rate was justified.[133]

The Conference Committee rejected the burden of proof modifica-

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125. In *Baker v. Commissioner*, for example, the D.C. Circuit noted that at the time the taxpayer filed his petition, the Government's action " 'appeared to be within the pale of reason.' " *Id.* at 391 (quoting Baker v. Commissioner, 787 F.2d 637, 642 (D.C. Cir. 1986)). Similarly, in *United States v. Balanced Financial Management, Inc.* the Tenth Circuit found that the Government's position in initiating the underlying contempt proceeding was not unreasonable. *Id.* (citing United States v. Balanced Fin. Management, Inc., 769 F.2d 1440, 1451 n.12 (10th Cir. 1985)).

126. *Id.* at 393.

127. *Id.* at 394.

128. 26 U.S.C. § 7430(f) (1982).

129. *Id.* § 7430 (Supp. V 1987), *re-enacting and amending* 26 U.S.C. § 7430 (1982). The 1986 changes apply to actions commenced after Dec. 31, 1985.

130. H.R. CONF. REP. No. 841, 99th Cong., 2d Sess., pt. 2, at 800 (1986), *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS 4888.

131. *Id.* at 801, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS at 4889.

132. *Id.*

133. *Id.*

tion, but adopted the substantially justified standard.[134] The Conference Committee also limited the scope of the Government's prelitigation conduct that could be considered.[135] Under the Conference Agreement, the position of the United States included the position taken by the United States in the civil proceeding, and any "*administrative action or inaction by the District Counsel* of the IRS (and all subsequent administrative action or inaction) upon which the proceeding is based."[136]

Although either the Examination Division or the Appeals Office of the IRS usually issues statutory notices of deficiency, IRS procedure in many instances requires the District Counsel to review the notices.[137] In these cases the District Counsel is involved in the administrative process and the statutory notice of deficiency is subject to the substantial justification test.[138] Despite the re-enacted statute's apparent clarification of the time at which the Government's action would be evaluated, two circuits took opposing views in interpreting the new provision.

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134. *Id.* at 802, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS at 4890.

135. *Id.* The Conference Committee also made the EAJA's net worth requirements applicable to § 7430. *Id.*

136. *Id.* (emphasis added).

137. Weintraub, *Recovery of Attorney's Fees in Tax Litigation*, L.A. LAW., July-Aug. 1987, at 38, 39. Section 4469 of the Internal Revenue Manual states that in certain cases notices of deficiency must be forwarded to District Counsel for review including the following:

> (a) All notices involving the fraud penalty or transferee liability. (b) All notices involving aggregate proposed deficiencies in a single case or a related group of cases in excess of $100,000, without considering the offsetting effect of any proposed overassessments. (c) All cases regardless of the amount involved in the following categories: 1. Cases involving questions as to the proper party to whom the notice should be sent or whether the time for appeal to the Tax Court is 90 days or 150 days; 2. Cases asserting alternative liabilities or alternative grounds in support of the determination; 3. Cases presenting issues which may affect many other taxpayers . . .; 4. Cases having newsworthy issues or personalities, the trial or settlement of which will probably receive newspaper attention; 5. Cases presenting difficult legal problems; 6. Cases closely related to other cases which are already in litigation; 7. Cases in which the issuance of the notice is suggested by the Department of Justice, Chief Counsel, or the District Counsel; 8. Cases in which there is a clear indication that the taxpayer will litigate the issues either in the Tax Court, the United States District Court, or the Court of Claims; 9. Cases in which the notice is issued prior to the complete investigation of the tax liability, due either to the running of the statute of limitations or the uncooperativeness of the taxpayer . . .; 10. Cases in which the proposed adjustments in the notice have international aspects; 11. Any other case where the issue may be particularly troublesome, unique, recurring, difficult, or which, in the opinion of the District Director or his/her designee, may warrant District Counsel review.

Notice of Deficiency and Claim Disallowance Review Procedure, [2 Audit] Internal Rev. Man. (CCH) §§ 4469, 4469(4) (Oct. 26, 1988).

138. Weintraub, *supra* note 137, at 39.

1. *Weiss v. Commissioner*

In *Weiss v. Commissioner*[139] the Second Circuit took an expansive view of the term "position of the United States" in interpreting the reenacted section 7430. The taxpayers in *Weiss* argued that the Commissioner of the IRS was not substantially justified in sending the taxpayers a notice of deficiency for partnership losses that the taxpayers had deducted.[140] The IRS failed to comply with 26 U.S.C. section 6221, which requires the IRS to conduct a partnership level audit before issuing a notice of deficiency to the partners.[141] Once the taxpayers filed a petition in Tax Court, the District Counsel quickly dismissed the case based on the IRS's failure to follow proper procedure.[142] When the taxpayers sought attorney's fees pursuant to section 7430, the Government argued that because the District Counsel had not reviewed the notice of deficiency, the position of the United States was not established until the District Counsel responded to the taxpayers' petition.[143]

The Second Circuit rejected this argument and held that once the Government takes a position that leaves the taxpayer no other choice than to seek a judicial remedy, the position of the United States is established regardless of whether it is the final administrative position or a position in litigation.[144] The Second Circuit found it irrelevant that the District Counsel was not involved in the case until after the taxpayer filed a petition. The court noted that the new definition of position of the United States retained the reference to civil proceeding.[145] Because some courts had determined that civil proceeding encompassed prelitigation conduct, the Second Circuit reasoned that the prelitigation action of issuing a notice of deficiency could establish the position of the United States even if the District Counsel had not been involved in that decision.[146] The court also noted that the legislative history of section 7430 indicated a congressional intent to incorporate the standards of the EAJA. Because the amended EAJA permitted a court to consider prelitigation conduct, the Second Circuit found no reason to interpret the slightly different language in section 7430 more restrictively.[147]

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139. 850 F.2d 111 (2d Cir. 1988).
140. *Id.* at 112-13.
141. *Id.*
142. *Id.* at 113.
143. *Id.* at 114.
144. *Id.* at 115.
145. *Id.* at 115-16.
146. *Id.* at 116 (citing Powell v. Commissioner, 791 F.2d 385 (5th Cir. 1986)).
147. *Id.*; *see also supra* note 90.

2. *Sher v. Commissioner*

In *Sher v. Commissioner*[148] the Fifth Circuit rejected *Weiss*'s broad interpretation of the 1986 re-enactment of section 7430, and concluded that the position of the United States was identified once the District Counsel became involved in the case.[149] The taxpayers in *Sher* received 775 dollars in interest income from A.G. Edwards, but A.G. Edwards erroneously reported to the IRS that the taxpayers received 1325 dollars in dividend income.[150] Neither the taxpayers nor the IRS knew of A.G. Edwards's mistaken report.[151] When the taxpayers became aware of the alleged deficiency, they tried to resolve the problem by having A.G. Edwards verify to the IRS that the taxpayers had received 775 dollars in interest income.[152] Nevertheless, the IRS issued a statutory notice of deficiency for 1325 dollars in dividend income.[153]

The taxpayers then filed a petition in Tax Court and included a copy of A.G. Edwards's letter and documentation.[154] In response the District Counsel denied all claims.[155] At the Appeals Office conference the taxpayers' attorney pointed out the mistake in A.G. Edwards's report.[156] The Government conceded the case once the mistake was discovered.[157]

In the taxpayers' suit for attorney's fees, the Fifth Circuit affirmed the Tax Court's determination that under the re-enacted section 7430, the position of the United States was identified once the District Counsel became involved in the case.[158] Even though the Fifth Circuit had permitted prelitigation conduct to be considered under the original section 7430,[159] the Fifth Circuit reasoned that the plain language of the re-enacted section precluded the consideration of prelitigation conduct if the District Counsel was not a participant in the administrative pro-

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148. 861 F.2d 131 (5th Cir. 1988).

149. *Id.* at 133.

150. *Id.* at 132.

151. *Id.*

152. *Id.*

153. *Id.* The taxpayers contacted the IRS, and a representative told the taxpayers that the notice was probably a mistake. *Id.*

154. *Id.* at 133.

155. *Id.*

156. *Id.* Although the report stated that the taxpayers had received $1325 in dividend income, they actually had received $775 in interest income, and the remaining $550 represented interest income earned by taxpayers' pension fund that mistakenly had been attributed to the taxpayers. *Id.*

157. *Id.*

158. *Id.*

159. *Id.* at 133 (citing Powell v. Commissioner, 791 F.2d 385, 392 (5th Cir. 1986)); *see supra* notes 121-25 and accompanying text.

cess.[160] A report of the Joint Committee on Taxation supported the Fifth Circuit's interpretation. The report stated that prelitigation actions or inaction by the IRS prior to the involvement of the District Counsel do not qualify as components of any attorney's fee award.[161] In *Sher* the District Counsel did not become involved in the case until she responded to the taxpayers' Tax Court petition. Accordingly, the Fifth Circuit held that the Government's position should be assessed from that point.[162]

When determining whether the District Counsel's answer to the taxpayers' petition was substantially justified, the Fifth Circuit stressed that none of the information which the taxpayers included with their petition indicated that A.G. Edwards's report was in error concerning the amount or type of income that the taxpayers had received.[163] Moreover, in their petition the taxpayers failed to deny the IRS assertion that A.G. Edwards paid them 1325 dollars in dividend income.[164] Since an assertion of a deficiency for 1325 dollars in dividend income and an acknowledgement of receipt of 775 dollars in interest income are not mutually exclusive, the court found that the District Counsel's answer was substantially justified.[165] The Fifth Circuit cautioned, however, that under different circumstances further investigation might be required before the IRS's answer would be adequate. The court stated that reliance on IRS files alone would have been insufficient if the contents of the file demonstrated the need for further investigation.[166]

III. Recent Development

In 1988, as part of the Taxpayers' Bill of Rights, Congress amended section 7430.[167] The amendment more closely conforms section 7430 with the EAJA and should resolve confusion in the circuits concerning the appropriate time at which to assess the Government's position. The House Bill did not propose any substantive changes to section 7430,[168] but the Senate suggested modifications that would have equalized sub-

160. *Sher*, 861 F.2d at 134.

161. Staff of the Joint Comm. on Taxation, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, at 300 (Joint Comm. Print 1986), *quoted in Sher*, 861 F.2d at 134.

162. *Sher*, 861 F.2d at 134.

163. *Id.* at 135.

164. *Id.* (citing U.S.T.C. R. Prac. & Proc. 142(a)).

165. *Id.*

166. *Id.*

167. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3333 (to be codified at 26 U.S.C. § 7430) (amending 26 U.S.C. § 7430 (Supp. V 1987)). The amended § 7430 applies to actions commenced after Nov. 10, 1988.

168. H.R. Conf. Rep. No. 1104, 100th Cong., 2d Sess., pt. 2, at 225 (1988), *reprinted in* 1988 U.S. Code Cong. & Admin. News 4515, 5285.

stantially the treatment of tax litigants and other civil litigants.[169] The Conference Committee agreement, which became law, was a political compromise.

A. *Senate Version of the 1988 Amendment to Section 7430*

The Senate proposed an expansion of recoverable costs to include not only reasonable litigation costs, but also reasonable administrative costs.[170] Reasonable administrative costs would be awarded after the earlier of the date of the thirty-day letter or the date of the statutory notice of deficiency.[171] Like the EAJA, the Senate placed the burden of proof on the Government to show that its position was substantially justified.[172]

In defining the position of the United States, the Senate proposal explicitly permitted examination of the Government's prelitigation conduct, clarifying the former confusion in the circuits. This position would be established on the later of the date of the thirty-day letter or the date on which the IRS received all of the pertinent information and legal arguments of the taxpayer.[173] The Senate Report illustrated that if

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169. *Id.* at 225-26, *reprinted in* 1988 U.S. CODE CONG. & ADMIN. NEWS at 5285-86.

170. *Id.* at 225, *reprinted in* 1988 U.S. CODE CONG. & ADMIN. NEWS at 5285. The Senate provision stated:

> Any person who substantially prevails in any action brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty may be awarded reasonable administrative costs incurred before the IRS and reasonable litigation costs incurred in connection with any court proceeding.
>
> For this purpose, reasonable litigation costs are defined as under current law, while reasonable administrative costs include (1) any administrative fees or similar charges imposed by the IRS, (2) reasonable expenses of expert witnesses, (3) the reasonable cost of any study, analysis, engineering report, test or project that is necessary for the preparation of the person's case, and (4) reasonable fees (generally not to exceed $75 per hour) paid or incurred for the services of a qualified representative of the taxpayer in connection with the administrative action.

Id.

171. The Senate Amendment stated that administrative costs were recoverable only if sucb costs meet one of the following conditions: "[I]ncurred after the earlier of (1) the date of the first notice of proposed deficiency (generally the 30-day letter) that allows the person an opportunity for administrative review in the IRS Office of Appeals, or (2) the date of the notice of deficiency described in section 6212 of the Code." *Id.*

172. The Senate Amendment stated:

> The burden of proof with respect to whether the position of the United States was substantially justified is shifted to the Government, so that if a taxpayer substantially prevails with respect to the amount in controversy or the most significant issue(s) in the case, the Government then must establish that its position was substantially justified in order to prevent the taxpayer from recovering costs.

Id.

173. *Id.* at 225-26, *reprinted in* 1988 U.S. CODE CONG. & ADMIN. NEWS at 5285-86. The provision stated:

> In determining whether the position of the United States was substantially justified, the posi-

a computer-generated notice proposed a deficiency based on a report of interest income filed by a third party, the position of the United States would not be determined until after the taxpayer had furnished the IRS with enough information to permit a reasonable person to conclude whether the notice should have been issued.[174]

B. *Conference Agreement of the 1988 Amendment to Section 7430*

During the conference meeting the House members did not agree with all of the Senate's changes.[175] The House members conceded the issue of awarding administrative costs, but refused to shift the burden of proof to the Government.[176] The conference reached a compromise on the issues of determining the time after which administrative costs would be awarded and the time for assessing the position of the United States. Under the Conference Agreement, both issues are decided as of the earlier of the date of the taxpayer's receipt of the decision of the IRS Office of Appeals or the date of the statutory notice of deficiency.[177]

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tion of the United States is determined as of the later of (1) the date of the first letter of proposed deficiency (generally the 30-day letter) that allows the taxpayer an opportunity for administrative review in the IRS Appeals Office (or, if no letter of proposed deficiency is sent, the date of the notice of deficiency described in section 6212 of the Code), or (2) the date by which the relevant evidence under the control of the taxpayer, as well as relevant legal arguments, with respect to such action have been presented by the taxpayer to IRS examination or Service Center personnel.

Id.

174. *Id.* at 226, *reprinted in* 1988 U.S. CODE CONG. & ADMIN. NEWS at 5286.

175. Telephone interview with Jeff Trinca, Legislative Aide to Sen. David Pryor of Arkansas (Jan. 26, 1989).

176. H.R. CONF. REP. No. 1104, *supra* note 168, at 226, *reprinted in* 1988 U.S. CODE CONG. & ADMIN. NEWS at 5286.

177. In regard to recoverable costs, tbe Conference Report stated:

The conference agreement follows the Senate amendment, with the modification that recoverable costs include only reasonable litigation costs plus reasonable administrative costs incurred after the earlier of (1) the date of the receipt by the taxpayer of the notice of the decision of the IRS Office of Appeals, or (2) the date of the notice of deficiency. Thus, with respect to a collection action, only reasonable litigation costs are recoverable under this provision.

Id. In regard to defining the position of the United States, the Conference Report stated:

The conference agreement follows the Senate amendment, with the modification that the position of the United States is determined as of the earlier of (1) the date of the receipt by the taxpayer of the notice of the decision of the IRS Office of Appeals, or (2) the date of the notice of deficiency. If neither is applicable, the position of the United States is that taken in the litigation.

Id.

IV. Analysis

A. *Effect of the 1988 Amendment*

The new definition of position of the United States is drafted in terms of the earlier of two dates in the administrative process. By explicitly permitting courts to consider the Government's administrative conduct, Congress has provided a bright-line rule that should resolve the split in the circuits concerning the 1986 formulation of section 7430. In *Weiss v. Commissioner*[178] the Second Circuit arguably ignored the plain language of the 1986 statute and permitted examination of the Government's prelitigation conduct before the District Counsel became involved in the case.[179] Under the 1988 amendment, courts can adhere to the plain meaning of the statute without violating the statute's purpose. This bright-line rule in turn will promote certainty in this area of the law.

B. *Consistency with Other Laws*

One problem with the 1988 amendment is that it retains the inconsistent treatment of taxpayer litigants compared with other civil litigants suing under the EAJA.[180] The Conference Committee rejected the Senate proposal to shift the burden of proof to the Government, as required by the EAJA.[181] Although litigants have no right to sue the Government,[182] no rational reason exists for disadvantaging only taxpayer litigants once Congress has made a policy decision to waive sovereign immunity.

While Congress was drafting the EAJA, the Treasury Department lobbied for separate treatment of tax cases.[183] The Treasury Department's reasons for separate treatment of tax cases are unpersuasive because they are equally applicable to other types of civil litigation. For example, the Tax Court is not the only court with a heavy caseload; most federal courts face this problem.[184] The fear that reimbursement for litigation costs will discourage settlement also applies equally to other civil litigation.[185] Furthermore, tax litigation is not unique in

178. 850 F.2d 111 (2d Cir. 1988).

179. *Id.* at 115.

180. For the differences between the EAJA and § 7430, see *supra* notes 49-54 and accompanying text.

181. H.R. Conf. Rep. No. 1104, *supra* note 168, at 226, *reprinted in* 1988 U.S. Code Cong. & Admin. News at 5286.

182. *See supra* note 33.

183. *See supra* notes 43-46 and accompanying text.

184. *See Attorney's Fees Hearings*, *supra* note 37, at 51 (remarks of Louise L. Hill, Assistant Prof. of Law, Univ. of Toledo College of Law).

185. *Id.*

dealing with complex issues that often result in no clear winner.[186] Failure to satisfy section 7430's prevailing party requirement simply means that the litigant will not receive an award. Because the Treasury Department's concerns are not unique to tax litigation, taxpayer litigants and other civil litigants should be subject to the same standards when suing the United States.

Furthermore, requiring taxpayers to bear the burden of proof in section 7430 cases while placing the burden of proof on the Government in EAJA cases is unreasonable because taxpayers need equal, if not greater, protection from arbitrary government action than other civil litigants. Tax cases differ from many civil actions under the EAJA in that the Government *always* initiates the administrative process in tax cases by seeking payment of a deficiency.[187] By contrast, a party suing under the EAJA often is seeking a government benefit[188] and voluntarily chooses to begin the administrative action.

The immense size of the IRS bureaucracy further supports the view that taxpayers may require greater protection from arbitrary government action. The IRS is the largest collection agency in the world[189] and has been compared to the Gestapo in its exercise of unchecked power and its propensity to harass defenseless citizens.[190] Equalizing the treatment of tax litigants and other civil litigants would help curb the abuse that often accompanies unchecked power.

V. CONCLUSION

The purposes of section 7430 are to remove economic deterrents for those seeking relief from arbitrary government action and to increase agency accountability.[191] If the burden of proof of unreasonable govern-

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186. *Id.*

187. The taxpayer may initiate *litigation* by filing a petition in Tax Court, *see supra* note 21 and accompanying text, or filing a refund suit in a United States district court or the United States Claims Court, *see supra* note 23. However, the IRS is responsible for initiating the *administrative* process.

188. *See, e.g.*, Brinker v. Guiffrida, 798 F.2d 661 (3d Cir. 1986) (challenging an agency's interpretation of insurance policy); Russell v. National Mediation Bd., 775 F.2d 1284, 1292 (5th Cir. 1985) (concerning failure to progress properly an application for investigation into a representational dispute); Save Our Ecosystems v. Clark, 747 F.2d 1240 (9th Cir. 1984) (seeking an injunction to halt herbicide spraying). In cases in which disability or other welfare benefits are concerned, however, the voluntariness of the action is questionable.

189. M. MULRONEY, FEDERAL TAX EXAMINATIONS MANUAL 1 (1985).

190. Barron, *Tyranny in the Internal Revenue Service*, READER'S DIG., Aug. 1967, at 44 (quoting Sen. Edward Long of Missouri), *reprinted in Taxpayers' Bill of Rights, 1987: Hearings on S. 579 and S. 604 Before the Subcomm. on Private Retirement Plans and Oversight of the Internal Revenue Service of the Senate Comm. on Finance*, 100th Cong., 1st Sess. 331 (1987).

191. Devin, *Tax Court Review of IRS' Position: When May Taxpayers Recover Legal Fees?*, 69 J. TAX'N 368, 369 (1988).

ment conduct remains with the taxpayer, a definition of the position of the United States that would assess government action earlier in the administrative process and award costs at the same time would foster the purposes of the statute.

The new law establishes the position of the United States late in the administrative process. The 1986 re-enactment of section 7430 likewise considered government action late in the administrative phase, but only in very limited circumstances.[192] Thus, although the 1988 amendment expanded the scope of government conduct that will be assessed, some taxpayers still will be deterred from seeking relief from arbitrary government action because they find it cheaper to pay the tax than to hire an advocate to prove that the IRS made an error.[193]

Adoption of the Senate's proposal concerning the time for assessing the Government's action and the time after which costs may be awarded would effectuate better the purposes of section 7430. The Senate proposal defined the position of the United States as the later of the date of the thirty-day letter or the date on which the taxpayer has presented the relevant information and legal arguments to the IRS examination or Service Center personnel.[194] It is possible that the taxpayer could provide the information and legal arguments during the earliest phase of the administrative action, the audit.[195] In such a case, the position of the United States would be established when the IRS issued a thirty-day letter.[196] If the IRS agent's position was overturned at the Appeals Office conference, the taxpayer might be able to recover costs at this early stage. Under the 1988 amendment as enacted, however, a taxpayer would be unable to recover costs even if the Appeals Office reversed the agent's decision because the United States' position would not be established until after the Appeals Office had rendered its decision.[197] Consequently, the Senate proposal would encourage early

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192. The 1986 version of § 7430 only considered administrative action from the time the District Counsel became involved in the case. *See supra* notes 135-38 and accompanying text.

193. *See Attorney's Fees Hearings, supra* note 37, at 65 (remarks of C. Fred Daniels of Dominick, Fletcher, Yeilding, Wood & Lloyd, P.A., Birmingham, Alabama) (stating that "[p]rior to enactment of section 7430, Internal Revenue Service personnel frequently admitted that they had no sound basis for some of their positions but that they knew it would cost more in attorney's fees to challenge them than the taxpayer could recover in tax").

194. *See supra* note 173.

195. *See supra* note 14 and accompanying text.

196. The audit precedes the 30-day letter. Therefore, if the taxpayer provided the relevant information during the audit, the latter of the two proposed Senate dates would be the date of the 30-day letter.

197. Under the Conference Agreement the earliest possible time at which a taxpayer could recover costs would be on the date of receipt of the Appeals Office's decision. *See supra* note 177 and accompanying text. Since the Appeals Officer would have acted reasonably in overturning the agent's arbitrary action, no recovery would be permitted.

identification of arbitrary government action and enhance agency accountability.

The Senate also proposed an early stage at which costs could be awarded: the earlier of the date of the thirty-day letter or the date of the statutory notice of deficiency.[198] In the preceding example, recoverable costs would start accruing after the date of the thirty-day letter. If the Government's position in issuing the thirty-day letter was not substantially justified, a taxpayer would be able to recover the cost of hiring an advocate to represent him during the Appeals Office conference.[199] Under the 1988 amendment as enacted, however, this expense would not be recoverable because costs do not begin accruing until after the Appeals Office conference. For a small taxpayer this change could make a significant difference. Under the Senate proposal, the possibility of recovering costs associated with the Appeals Office conference would encourage small taxpayers to vindicate their rights by pursuing the action. Under the 1988 amendment, however, small taxpayers still may find it more economical to pay the tax even if the IRS made an error. Thus, the Senate proposal would further section 7430's policy of removing economic deterrents in taxpayer actions against arbitrary government action.

In addition, the Senate proposal would promote agency accountability. If taxpayers were able to recover costs starting at the thirty-day letter stage, the IRS would be more careful when determining whether the facts and arguments stated in the revenue agent's report warrant the issuance of a thirty-day letter.[200] Improved quality control early in the administrative process would promote efficiency and fairness. Rather than clogging the courts, the Senate's proposal potentially would decrease the number of cases that would require litigation.

The Senate's proposal also would address the concern that the IRS not be held responsible for errors if the correct information was not within its control.[201] For instance, in *Sher v. Commissioner*[202] neither the taxpayer nor the IRS was aware that A.G. Edwards's report to the IRS concerning the taxpayers' receipt of dividend income was mistaken as to the amount and character of the income.[203] The taxpayers did not disclose the error when they filed a petition in Tax Court,[204] and taxpayers' counsel did not detect the mistake until the settlement negotia-

198. *See supra* note 171 and accompanying text.
199. The representative need not be an attorney. *See* M. SALTZMAN, *supra* note 17, at 1-47.
200. *See supra* notes 16, 17, and accompanying text.
201. *See supra* note 178 and accompanying text.
202. 861 F.2d 131 (5th Cir. 1988).
203. *Id.* at 132.
204. *Id.* at 135.

tions.[205] Because the Senate's proposal establishes the position of the United States on the later of the date of the thirty-day letter or the date on which the taxpayer has presented the relevant information to the Government, the Government's position in *Sher* would not have been established until the error in the report had been disclosed, and no costs would have been awarded.[206]

The 1986 and 1988 formulations of section 7430 have conformed the statute more closely with the EAJA. Taxpayer litigants, however, are still at a disadvantage compared to other civil litigants because the taxpayer has the burden of proof in section 7430 cases. By establishing the position of the United States and by awarding costs early in the administrative phase, the Senate proposal would have offset some of the disadvantages taxpayers suffer in carrying the burden of proof. In rejecting the Senate's proposal, Congress lost an opportunity to equalize treatment among litigants suing the United States.

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205. *Id.* at 133.

206. Arguably, the taxpayers possessed information of an inconsistency that the IRS did not possess. The taxpayers knew that they had received $775 in interest income from A.G. Edwards. *Id.* at 132. The taxpayers also knew that the IRS had issued a notice of deficiency for $1325 in dividend income. *Id.* at 135. Critically, the taxpayers failed to deny receipt of the $1325 in dividend income in their Tax Court petition. *Id.* Receipt of dividend income and receipt of interest income from the same company are not mutually exclusive events.

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