



OFFICE OF  
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224  
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: ASSISTANT CHIEF COUNSEL (FIELD SERVICE)  
CC:DOM:FS:PROC

SUBJECT: INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD  
SERVICE ADVICE

This Field Service Advice responds to your memorandum dated January 20, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

Taxpayers =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

Year 6 =

Year 7 =

Year 8 =

Year 9 =

Year 10 =

Year 11 =

Year 12 =

\$a =

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\$b =

\$c =

\$d =

Tax Shelter =

### ISSUE

Whether the Taxpayers are the prevailing party as defined in I.R.C. §7430(c)(4).

### CONCLUSION

That the Taxpayers are not the prevailing party.

### FACTS

Taxpayers claimed deductions for tax Years 1 and 2. These deductions related to their investment as a limited partner in a partnership. The partnership participated in the Tax Shelter. In September of Year 5, the Service issued a notice of deficiency to Taxpayers disallowing the Tax Shelter losses for Years 1 and 2. The deficiencies were in the amounts of \$a and \$b, respectively. In response to this notice, Taxpayers filed a petition with the Tax Court on December 27, Year 5.

In Year 7, a revenue agent in the Service's Examination Division was assigned to examine Taxpayers' income tax returns for the tax Years 3 and 4. In Year 7, the revenue agent mailed the Taxpayers a letter notifying them that their tax returns for tax Years 3, 4, 5 and 6 would be examined regarding deductions claimed for the Tax Shelter. The revenue agent was not aware of any claimed Tax Shelter deductions for tax Years 1 and 2, nor of the docketed Tax Court case involving those tax years.

On July 3, Year 7, the revenue agent mailed Taxpayers a form letter proposing to settle the Tax Shelter issues by allowing cash out-of-pocket expenses (cash investment) as a deduction in the initial year of investment. The letter further stated, "[w]e are also making the same cash offer with respect to any other tax shelter issue, involving the initial [Y]ear [2] and prior which is included in the enclosed Revenue Agent's Report." The letter did not state on its face which tax years were included in the proposed settlement, but the letter stated that an examination report and a Form 906, Closing Agreement on Final Determination Covering Specific Matters, were enclosed. Because the revenue agent incorrectly believed that tax Year 3 was the initial year of investment, the examination report and the closing agreement allowed Taxpayers a deduction of \$d in Year 3.

On August 22, Year 7, the Taxpayers mailed to the revenue agent a Cash Settlement Offer Statement, purporting to accept the cash out-of-pocket offer, and

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a handwritten notice stating Taxpayers had invested \$d in the Tax Shelter. In January of Year 8, the Taxpayers and the Service signed a Form 906 that stated the Taxpayers had paid \$d in Year 3.

On March 2, Year 9, an Appeals Officer mailed a letter to the Taxpayers, advising them that the Tax Court had issued its opinion in the tax shelter test case. She invited them to settle their case for Years 1 and 2 in accordance with the opinion but received no response. The Appeals Officer mailed another letter to the Taxpayers on October 14, Year 10, advising them that the Court of Appeals had affirmed the Tax Court's decision in the test case, and inviting them to settle tax Years 1 and 2. Taxpayers responded in a letter that they had already settled the matter via the closing agreement signed in Year 8.

In Year 10, the Taxpayers' attorneys contacted District Counsel about the Year 1 and Year 2 deficiency case and also requested an abatement of the interest that accrued for these years. The District Counsel attorney advised the Taxpayers' attorney that he lacked jurisdiction over the abatement of interest matter and that the Taxpayers would instead need to file their request for abatement of interest with the Service. The Taxpayers submitted their request for abatement of interest on February 10, Year 11. The request was denied and the Taxpayers sought Appeals consideration. On April 16, Year 11, the Appeals Office issued a Notice of Final Determination denying the Taxpayers' request for interest abatement.

The Taxpayers filed a Petition for Review of Failure to Abate Interest with the Tax Court on September 8, Year 11. The District Counsel attorney filed a motion to dismiss the interest abatement case for lack of jurisdiction on the grounds that a final determination should not have been issued. The District Counsel attorney argued that the Taxpayers' request for abatement was premature because the

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interest had not yet been assessed.<sup>1</sup> The Taxpayers filed an objection to this motion.

Also in September of Year 11, the Taxpayers filed a motion to enforce the settlement agreement in the deficiency case. In the motion, they asked the court “to enforce a [Year 7] settlement agreement between Taxpayers and the Service, and thereby preclude the Service from assessing back taxes, penalties and interest for disallowed deductions taken by Taxpayers” in Years 1 and 2. District Counsel filed an objection to this motion.

At a hearing held on these two cases on April 21, Year 12, the judge consolidated the two cases for purposes of trial, briefing and opinion. The judge indicated that the revenue agent should have realized that the Taxpayers had made investments in the Tax Shelter prior to Year 3 based on (1) the settlement offer contained in the form letter and (2) the fact that he was auditing the Taxpayers for tax Years 3, 4, 5 and 6. The Court stated that the revenue agent also should have checked the Service’s computer to see whether there was a litigation freeze code on prior years. He told the parties that they should settle the case and suggested the terms of the settlement. Consequently, District Counsel agreed to spread the \$d deduction over a period of three years and allow a \$c deduction in Years 1, 2 and 3. In return, the Taxpayers agreed to waive the statute of limitations for tax Year 3 in order to permit a reduction of the deduction from \$d to \$c.

In light of the resolved deficiency case, and under pressure from the Court, District Counsel also agreed that it would abate interest from April 1, Year 8 until 30 days after the parties agreed to the computations of the deficiencies and interest under

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<sup>1</sup> District Counsel could have moved for summary judgment on the grounds that the Service could not have abused its discretion because it was not authorized to abate unassessed interest. See I.R.C. § 6404(e)(1). This route was not chosen because of the concern that a judgment could preclude Taxpayers from petitioning the Tax Court for these tax periods in the future. See Woodral v. Commissioner, 112 T.C. 19 (1999) where the Court held that because the Service had no authority to abate interest on employment taxes, the Service could not have committed an abuse of discretion in failing to abate it. The Court also stated that since the Commissioner had no authority to abate assessments of interest on employment taxes under I.R.C. § 6404(e), the Commissioner could not have committed an abuse of discretion, for a person with no discretion simply cannot abuse it. Similarly with this case, since I.R.C. § 6404(e) does not give the Service authority to abate unassessed interest, the Service could not have abused its discretion in failing to abate the unassessed interest for the tax Years 1 and 2. However, this case and Woodral are distinguishable on the separate issue of the Tax Court’s jurisdiction upon the issuance of a notice of determination. In Woodral, the notice of determination was valid. In this case, it was not.

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the settlement agreement. In exchange, the Taxpayers agreed to withdraw their objection to the motion to dismiss for lack of jurisdiction. The parties agreed to negotiate the attorneys costs and fees issue separately from the underlying tax deficiency and interest abatement matters. The Court indicated that it would dismiss the abatement case when the parties provided it with a letter stating the final computations and Taxpayers' date of payment.

Taxpayers also assert that the Service, through its District Counsel attorney, has exposed itself to attorneys fees by engaging in an "aggressive motions practice" and "unreasonably and vexatiously" multiplying the proceedings in the two cases.

### LAW AND ANALYSIS

I.R.C. § 7430(a) provides for the award of reasonable administrative and litigation costs to a taxpayer in administrative or court proceedings brought against the United States involving the determination of any tax, interest or penalty pursuant to the Code. An award of administrative or litigation costs<sup>2</sup> may be made where the taxpayer: (1) meets the net worth requirements; (2) is the prevailing party; (3) has exhausted available administrative remedies; and (4) did not unreasonably protract the administrative or judicial proceeding. This memorandum confines its discussion to whether the Taxpayers are the prevailing party.

I.R.C. § 7430(c)(4) defines the term "prevailing party" in pertinent part as any party in a proceeding referred to in I.R.C. § 7430 who (1) has substantially prevailed with respect to the amount in controversy, or (2) has substantially prevailed with respect to the most significant issue or set of issues presented.

I.R.C. § 7430(c)(4)(B) provides generally that a party shall not be treated as the prevailing party in a proceeding to which this section applies if the United States establishes that its position in the proceeding was substantially justified.<sup>3</sup>

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<sup>2</sup> I.R.C. § 7430, as amended by Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, § 292(a), 96 Stat. 324, 572, applies to cases instituted after February 28, 1983 and before December 31, 1985. Because Taxpayers filed their petition in the deficiency case between those two dates, this version of I.R.C. § 7430(b)(1) applies to the notice of deficiency case. Under I.R.C. § 7430(b)(1), the maximum dollar amount which may be awarded with respect to any prevailing party in any civil proceeding shall not exceed \$ 25,000.

<sup>3</sup> Tax Reform Act of 1986 ("TRA 1986") amended the definition of a "prevailing party" so that to be a "prevailing party," the taxpayer must show that the position of the United States was "not substantially justified" as opposed to the prior standard of "unreasonable." TRA 1986 § 1551(d)(1), 100 Stat. 2752. The Tax Court has held that

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Consolidation of Cases

I.R.C. § 7430(e) provides that multiple cases that could have been joined or consolidated shall be treated as one proceeding unless the court determines that it would be inappropriate to treat such actions as joined or consolidated for purposes of I.R.C. § 7430. This provision does not apply to the Taxpayers' cases but, even if it did, it would have no impact on the attorney fee result.

First, the parties have agreed to, and the Court will enter, an order dismissing the abatement of interest case for lack of jurisdiction. As a result of the dismissal, there will no longer be two cases to consolidate. Accordingly, it is no longer logical to continue to treat such actions as joined or consolidated for purposes of I.R.C. § 7430.

Second, even if the Court were to consolidate these cases, the Court's practice is to adopt an issue-by-issue approach in determining the amount of attorneys fees to be paid under I.R.C. § 7430. See Lozon v. Commissioner, T.C. Memo. 1997-537 (citing Powers v. Commissioner, 51 F.3d 34, 35 (5<sup>th</sup> Cir. 1995); Swanson v. Commissioner, 106 T.C. 76, 102 (1996); and § 301.7430-5(c)(2), Regulations on Procedure and Administration). In this approach, the Court apportions the requested attorneys fees between those issues for which the Commissioner was substantially justified, and those for which he was not. Accordingly, even if the Court consolidates the deficiency and interest abatement cases, it should still analyze each issue separately in order to determine the amount of attorneys fees and costs.

Notice of Deficiency Case

The Taxpayers may argue they prevailed with respect to the litigation concerning the income tax case because they prevailed with respect to the most significant issue of the case. The Taxpayers succeeded in spreading their \$d deduction over three years beginning in Year 1. On the other hand, the Service could argue that the most significant issue in the case was whether the \$d deduction in Year 3 should have been reduced. These determinations will ultimately be based on how the Court views the matter. However, if the Court considers that the Taxpayers are the prevailing party in the deficiency case, they are still not considered the prevailing party for purposes of I.R.C. § 7430(c)(4) if the Service's position in the litigation was substantially justified.

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the substantial justification standard is essentially the prior law's reasonableness standard couched in new language. Maggie Management Co. v. Commissioner, 108 T.C. 430, 442 (1997).

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Under I.R.C. § 7430(c)(4)(B)(i), a taxpayer is entitled to an award of costs and attorneys fees only if the United States fails to establish that its position in the proceedings was substantially justified. See Estate of Wall v. Commissioner, 102 T.C. 391 (1994) (mere fact that government is unsuccessful at litigation or concedes the case is not determinative of whether its position was substantially justified); see also Vanderpool v. Commissioner, 91 T.C. 367 (1988); Wasie v. Commissioner, 86 T.C. 962 (1986).

The Service's administrative and litigation positions are substantially justified if they have a reasonable basis in both law and fact. Pierce v. Underwood, 487 U.S. 552, 565 (1988); Swanson v. Commissioner, 106 T.C. 76, 86 (1996). A reasonable basis exists if legal precedent substantially supports the Service's position given the facts available. Coastal Petroleum Refiners v. Commissioner, 94 T.C. 685, 688 (1990). The fact that the Service eventually loses or concedes a case does not by itself establish that the position taken is unreasonable, but it is a factor that may be considered. Swanson, 106 T.C. at 94. See also Sokol v. Commissioner, 92 T.C. 760, 767 (1989).

The Tax Court has considered the reasonableness standard in several cases. See Mearkle v. Commissioner, 90 T.C. 1256 (1988) (taxpayer, who was the prevailing party in court, was not entitled to attorneys fees and costs because he did not show that the government's position was unreasonable); Cooper v. U.S., 60 F.3d 1529 (11<sup>th</sup> Cir. 1995) (IRS is unreasonable in imposing I.R.C. § 6672 liability against person who was only investor in restaurant); U.S. v. Estridge, 797 F.2d 1454 (8<sup>th</sup> Cir. 1986) (litigation costs awarded where IRS did not diligently investigate which of several persons was liable for the I.R.C. § 6672 penalty); and Powers v. Commissioner, 100 T.C. 457 (1993) (where IRS disallowed all deductions claimed on the return, but had not conducted an audit and had made no attempt to obtain information about the case before adopting the position in the notice, the IRS was not substantially justified merely because the notice of deficiency was valid).

The Service's litigation position in the deficiency case was not unreasonable. The Taxpayers had already received, pursuant to the explicit terms of the closing agreement, a deduction in Year 3 of their entire cash investment in the Tax Shelter. The closing agreement specifically stated that losses and deductions are not deductible by the Taxpayers in any year before Year 3 or after Year 3. The Taxpayers must have been aware that their initial year of investment was Year 1 and not Year 3, yet the Taxpayers sought the benefits of the Year 3 settlement. Notwithstanding that the Service settled Years 1 and 2, its litigation position for Years 1 and 2 was reasonable.

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### Abatement of Interest Case

In order for the Tax Court to have jurisdiction under I.R.C. § 6404, the taxpayer must meet the net worth and size requirements referred to in I.R.C. § 7430(c)(4)(A)(ii) and bring an action within 180 days after receiving a final determination not to abate interest from the Service. The Tax Court's jurisdiction is limited to determining whether the Secretary's failure to abate interest was an abuse of discretion.

Taxpayers filed a request for abatement of interest with the Service. The Service considered the claim and ultimately issued a final determination not to abate interest. As a result of the Service's denial of their claim, Taxpayers petitioned the Tax Court. The Service moved to dismiss the case for lack of jurisdiction, taking the position that the final determination sent to Taxpayers was invalid.

Specifically, the Service argued that because the Taxpayers' request for abatement of interest was premature, as no interest had yet been assessed, the Service should have rejected the claim instead of making a determination. The Taxpayers objected to the motion and a hearing was held on April 21, Year 12. As a result of settlement negotiations at the hearing, the Taxpayers agreed to withdraw their objection to District Counsel's motion to dismiss the interest abatement case for lack of jurisdiction. Accordingly, Taxpayers are not the prevailing party for purposes of I.R.C. § 7430(c)(4).

Even if the Court decides that the Taxpayers are the prevailing party, I.R.C. § 7430(c)(4)(B)(i) provides that a party shall not be treated as a prevailing party if the United States establishes that the position of the United States<sup>4</sup> in the proceeding was *substantially justified*. What constitutes whether the Commissioner's position is substantially justified or not is discussed in detail in the Notice of Deficiency section of this memorandum, see supra p. 7.

In this case, the Service was substantially justified when it denied the abatement of interest claim. The Service did not have the authority under I.R.C. § 6404(e)(1) to abate because the Service had yet to make an assessment of the interest. I.R.C. § 6404(e)(1) states that the Secretary may abate interest "[i]n the case of any *assessment of interest* on - (A) any deficiency attributable in whole or in part to any unreasonable error or delay by an officer or employee of the Internal Revenue Service...in performing a ministerial or managerial act." Emphasis added. Since no assessment had been made, the Service correctly denied the abatement claim.

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<sup>4</sup> Pursuant to I.R.C. § 7430(c)(7) the position taken by the Service is the position taken in the judicial proceeding.



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I.R.C. § 6673 Sanctions and Costs

The Taxpayers, in addition to requesting relief under I.R.C. § 7430, are seeking recovery under I.R.C. § 6673 as well. I.R.C. § 6673 provides for an award of costs, expenses and attorneys fees where an attorney, including an attorney appearing on behalf of the Commissioner, has unreasonably and vexatiously<sup>5</sup> multiplied the proceedings in any case. I.R.C. § 6673(a)(2) is derived from 28 U.S.C. § 1927 (1988). See H. Rept. 101-247, at 1399–1400 (1989).

I.R.C. § 6673(a)(2) provides in pertinent part:

Whenever it appears to the Tax Court that any attorney or other person admitted to practice before the Tax Court has multiplied the proceedings in any case unreasonably and vexatiously, the Tax Court may require ...

(B) if such attorney is appearing on behalf of the Commissioner of Internal Revenue, that the United States pay such excess costs, expenses, and attorneys fees in the same manner as such an award by a district court.<sup>6</sup>

In Harper v. Commissioner, 99 T.C. 533 (1992), the Tax Court noting the dearth of judicial opinions interpreting and applying I.R.C. § 6673(a)(2), relied on case law under 28 U.S.C. § 1927 for guidance on the level of misconduct justifying sanctions. The majority of Courts of Appeals require a showing of bad faith as a condition of imposing sanctions. See also Oliveri v. Thompson, 803 F.2d 1265, 1273 (2<sup>nd</sup> Cir. 1986); United States v. Associated Convalescent Enters. Inc., 766 F.2d 1342 (9<sup>th</sup> Cir. 1985) (sanctions under 28 U.S.C. § 1927 are appropriate where the conduct causing multiplication of the proceedings was reckless or in bad faith).

In Harper, counsel for the taxpayer (1) failed to comply with the Court's order to produce documents requested by the Commissioner pursuant to discovery, (2) filed a frivolous motion for summary judgment, (3) failed to file a proper trial memorandum, (4) failed to prepare for trial as directed by the Court, and (5) failed to respond to the Commissioner's motion for sanctions. The Tax Court held that counsel for the taxpayer had unreasonably and vexatiously multiplied the proceedings by displaying a contemptuous disregard for the Court's Rules and orders, acting in bad faith, and knowingly abusing the judicial process throughout

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<sup>5</sup>Blacks Law Dictionary 1559 (7<sup>th</sup> ed. 1999), defines "vexatious" as: "(of conduct) without reasonable or probable cause or excuse; harassing; annoying".

<sup>6</sup>I.R.C. § 6673(a)(2) is applicable "to positions taken after December 31, 1989, in proceedings which are pending on, or commenced after such date". OBRA 1989 § 7731(d), 103 Stat. 2106, 2402; see Harper v. Commissioner, 99 T.C. 533 (1992).

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the course of the proceeding. Id. at 549. See also Murphy v. Commissioner, T.C. Memo. 1995-76.

However, the Tax Court had not had the occasion to apply I.R.C. § 6673(a)(2) to misconduct of a Government attorney before the case of Dixon v. Commissioner, T.C. Memo. 2000-116 (Mar. 31, 2000)<sup>7</sup>. Dixon involved consolidated cases arising from the Service's disallowance of interest deductions claimed by participants in various tax shelters. The merits of the tax shelter cases were litigated in a consolidated trial of eight petitioners whose cases had been designated as "test cases." John Thompson and John Cravens were two of the petitioners in the test cases. Following the trial, the Court sustained virtually all of the Service's determinations in each of the test cases. It then came to light that prior to trial of the test cases, the Service's attorneys entered into contingent settlement agreements with Thompson and Cravens that had not been disclosed to the Court, to the other test case petitioners, or to their counsel. There were a series of motions, hearings, and appeals to determine the impact of the contingent settlement agreement on the trial, but ultimately the Court again sustained the Service's determination. In Dixon, the Court held that the Service's attorneys intentionally misled the Court, before, during and after the trial of the test cases. In fact, the Service conceded that its two attorneys involved in the settlements engaged in misconduct in the trial of the test cases. Further, the Court stated that the misconduct led the Court of Appeals to remand the test cases to the Tax Court for an evidentiary hearing and caused substantial continuing delay in the resolution of the tax shelter cases. The Court granted petitioners' motions for attorneys fees and costs.

Nothing close to the outrageous abuses described above occurred in either the deficiency or interest cases.

Taxpayers' counsel argues that the District Counsel attorney "resisted consolidation, engaged in an aggressive and costly motions practice requiring the filing of numerous documents." See Taxpayers' Memorandum to National Office dated January 27, 2000. The file indicates that the District Counsel attorney did not file aggressive motions nor engage in costly motions practice. He filed an objection to the petitioners' motion to enforce the settlement agreement; a motion to amend answer to assert an estoppel defense to the Taxpayers' claim that they were entitled to a cash-out deduction in any year other than Year 3; a motion for partial summary judgment on the issue of whether the petition was valid in the income tax case, because counsel for petitioners refused to ratify the petition; and a motion to dismiss the interest abatement case. Clearly the pleadings filed by the District

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<sup>7</sup>In Dixon, the petitioners did not qualify for, and therefore were unable to get, attorneys fees under I.R.C. § 7430(c)(4) because they were not "prevailing parties."

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Counsel attorney were appropriate and do not, in any way, indicate reckless or bad faith conduct.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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By: \_\_\_\_\_  
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