B535 v. Commissioner, 90 T. C. 535 (1988)

The IRS's reliance on a proposed regulation is considered reasonable for purposes of awarding litigation costs under section 7430 until the regulation is judicially overturned.

Summary

In B535 v. Commissioner, the Tax Court addressed whether the IRS's reliance on a proposed regulation under section 280A was reasonable for denying litigation costs under section 7430. The IRS had determined a tax deficiency based on the regulation, which the court later invalidated in Scott v. Commissioner. The court held that the IRS's position was reasonable because it relied on the proposed regulation, and its concession within three months after the regulation's invalidation was timely. This decision underscores that reliance on proposed regulations shields the IRS from litigation cost awards until a court explicitly invalidates them, impacting how taxpayers and their attorneys approach similar disputes.

Facts

The IRS determined a deficiency in petitioners' 1981 federal income tax based on a proposed regulation under section 280A concerning home office deductions. The petitioners challenged this deficiency, referencing the court's decision in Scott v. Commissioner, which invalidated the regulation. The IRS offered to concede the case after the Scott decision, but petitioners sought a decision that would serve as precedent. Ultimately, the IRS moved to dismiss, and the court entered a decision of no deficiency. Petitioners then moved for litigation costs under section 7430, arguing that the IRS's position was unreasonable.

Procedural History

The petition was filed on August 9, 1984. The IRS moved to dismiss the case at the court's February 10, 1986, calendar in New York City, which was granted, and a decision of no deficiency was entered on February 19, 1986. Petitioners moved for litigation costs on March 21, 1986, prompting the court to vacate its decision to consider this motion. The IRS objected on May 20, 1986.

Issue(s)

1. Whether the IRS's reliance on a proposed regulation under section 280A was reasonable for purposes of denying litigation costs under section 7430.
2. Whether the IRS's position became unreasonable after the court invalidated the proposed regulation in Scott v. Commissioner.

Holding

1. Yes, because the IRS's reliance on a proposed regulation is reasonable until it is

judicially overturned.
2. No, because the IRS conceded the case within a reasonable time after the regulation's invalidation.

Court's Reasoning

The court reasoned that reliance on a proposed regulation should be treated similarly to reliance on a final regulation for section 7430 purposes. The court cited that final regulations have the status of law until invalidated, and thus, reliance on them is generally reasonable. It extended this reasoning to proposed regulations, noting that they should carry the same weight for determining reasonableness under section 7430 until judicially disapproved. The court emphasized that the purpose of section 7430 is to deter abusive actions by the IRS, not to challenge its reliance on regulations. Furthermore, the court found that the IRS's concession within three months of the Scott decision was timely, reinforcing that the IRS's position remained reasonable post-invalidation. The court concluded that the IRS's reliance on the proposed regulation and its subsequent actions insulated it from an award of litigation costs.

Practical Implications

This decision impacts how taxpayers and their attorneys approach disputes involving IRS reliance on proposed regulations. It establishes that the IRS can reasonably rely on proposed regulations for denying litigation costs until a court invalidates them, affecting legal strategies in tax litigation. Taxpayers must now consider the potential for extended litigation if challenging a regulation, as the IRS has a buffer period post-invalidation to concede without facing cost awards. This ruling may encourage the IRS to promulgate proposed regulations more freely, knowing they have protection from litigation costs. Subsequent cases, such as Spirtis v. Commissioner, have applied similar reasoning, reinforcing the precedent set by B535. Attorneys should advise clients on the risks and timelines associated with challenging IRS positions based on proposed regulations.

