87 T.C. 527 (1986)

Reliance by the IRS on a proposed regulation, even if later deemed inconsistent with the statute, is generally considered a reasonable position for the purpose of awarding litigation costs under Section 7430, unless and until the regulation is overturned by a court and for a reasonable time thereafter.

Summary

In *Mearkle v. Commissioner*, the Tax Court addressed whether the IRS's position in disallowing a home office deduction based on a proposed regulation was unreasonable, thus entitling the taxpayers to litigation costs. The IRS had relied on a proposed regulation that defined "gross income derived from such use" in a way the court later found inconsistent with the statute in *Scott v. Commissioner*. The court held that the IRS's reliance on a proposed regulation was reasonable until it was judicially invalidated and for a reasonable period afterward. Therefore, the IRS's concession within three months of the *Scott* decision's appeal period expiring was deemed reasonable, and litigation costs were denied.

Facts

Petitioners, Russell and Virginia Mearkle, claimed a deduction for a home office in 1981. The IRS disallowed the deduction based on Proposed Income Tax Regulation §1.280A-2(i)(2)(ii), which defined "gross income derived from such use" of a home office as net of certain business expenses. This definition effectively limited the deductible home office expenses. The Tax Court, in *Scott v. Commissioner*, 84 T.C. 683 (1985), held this proposed regulation inconsistent with the statute, Section 280A. Following the *Scott* decision, the IRS conceded the Mearkles' case but petitioners sought litigation costs under Section 7430, arguing the IRS's initial position was unreasonable.

Procedural History

1. Petitioners filed a petition with the Tax Court on August 9, 1984, contesting the deficiency determined by the IRS.

2. After the Tax Court's decision in *Scott v. Commissioner* (84 T.C. 683 (1985)) which invalidated the proposed regulation the IRS relied upon, the IRS offered to concede the *Mearkle* case on October 16, 1985.

3. Petitioners sought a decision that would serve as precedent, but the Tax Court granted the IRS's motion to dismiss on February 10, 1986, and entered a decision of no deficiency on February 19, 1986.

4. Petitioners moved for litigation costs on March 21, 1986, under Section 7430.

5. The Tax Court vacated its decision to consider the motion for litigation costs and

© 2025 SCOTUSreports.com. All rights reserved.

ultimately denied the motion.

Issue(s)

1. Whether the IRS's position in disallowing the home office deduction, based on a proposed regulation later deemed inconsistent with the statute, was unreasonable under Section 7430, thus entitling the petitioners to litigation costs?

2. Whether reliance on a proposed regulation constitutes a reasonable position for the IRS, at least until the regulation is judicially disapproved?

Holding

1. No. The IRS's position was not unreasonable because it was based on a proposed regulation, and reliance on such a regulation is generally considered reasonable.

2. Yes. Reliance on a proposed regulation is considered a reasonable position for the IRS under Section 7430 until the regulation is overturned by a court and for a reasonable time thereafter.

Court's Reasoning

The Tax Court reasoned that while proposed regulations do not carry the same legal weight as final regulations in terms of judicial deference, the IRS's reliance on them for enforcement purposes should be considered reasonable under Section 7430. The court drew an analogy to final regulations, stating that the IRS is generally insulated from litigation costs awards when relying on final regulations, as these have the status of law until invalidated. The court stated, "Were a final regulation at issue here, the Commissioner would, except in the most unusual of circumstances, be insulated from a section 7430 award…"

The court emphasized that Section 7430 was intended to deter abusive actions by the IRS in specific cases, not to penalize the IRS for relying on duly promulgated or proposed regulations affecting classes of taxpayers. The court concluded, "We do not think Congress sought to deter respondent from relying upon a regulation duly promulgated or proposed. Section 7430 aims instead at deterring specific abusive actions by respondent's employees, against specific taxpayers, in specific cases."

The court found that the IRS's concession of the case within three months after the appeal period expired in *Scott* was a reasonable timeframe, further supporting the conclusion that the IRS's overall position was not unreasonable for the purposes of Section 7430.

Practical Implications

Mearkle v. Commissioner provides significant practical guidance on the "reasonableness" standard under Section 7430 in the context of IRS reliance on

© 2025 SCOTUSreports.com. All rights reserved.

regulations. It establishes that the IRS is generally justified in taking positions based on both proposed and final regulations without being deemed unreasonable for litigation costs purposes, at least until a court definitively invalidates the regulation. This ruling gives the IRS leeway to enforce regulations, even proposed ones, without undue fear of cost awards, promoting consistent application of tax law as interpreted by the Treasury. For taxpayers, this case clarifies that challenging IRS positions based on existing regulations, even if proposed, and seeking litigation costs will be difficult unless the IRS persists unreasonably long after a regulation is invalidated. It highlights the importance of focusing on whether the IRS's conduct in a *specific* case is abusive or overreaching, rather than merely disagreeing with a regulatory interpretation.

© 2025 SCOTUSreports.com. All rights reserved.