Phillips v. Commissioner, 88 T. C. 529 (1987)

A taxpayer may recover reasonable litigation costs from the IRS if they substantially prevail and the IRS's position was unreasonable, even if the taxpayer's own actions contributed to the litigation.

Summary

Kenneth Phillips sought to recover litigation costs after successfully litigating against the IRS's determination that he owed tax deficiencies for not filing joint returns. The IRS's position was based on a prior Tax Court decision, but contradicted its own revenue rulings. The Tax Court held that Phillips was entitled to recover costs related to the unreasonable positions taken by the IRS, but not those resulting from his own failure to file timely returns. This case establishes that taxpayers can recover litigation costs if the IRS's position is unreasonable, but such recovery may be limited by the taxpayer's own actions.

Facts

Kenneth Phillips did not file income tax returns for 1979, 1980, and 1981. The IRS issued a notice of deficiency asserting that Phillips owed taxes and additions for those years. After the notice was issued, Phillips claimed he was entitled to file joint returns with his wife, which would eliminate his tax liability due to foreign tax credits. The IRS relied on the Tax Court's decision in Durovic v. Commissioner to deny Phillips's claim, despite its own revenue rulings supporting his position. Phillips prevailed in the underlying case and then sought to recover his litigation costs under section 7430.

Procedural History

The Tax Court initially determined in Phillips v. Commissioner, 86 T. C. 433 (1986) that Phillips owed no deficiencies because he was entitled to file joint returns. Phillips then filed a motion for reasonable litigation costs, which the Tax Court considered in the present case. The court vacated its prior decision pending resolution of the costs issue and ultimately held that Phillips was entitled to some, but not all, of his litigation costs.

Issue(s)

1. Whether Phillips substantially prevailed in the litigation as required by section 7430(c)(2)(A)(ii)?
2. Whether Phillips exhausted his administrative remedies as required by section 7430(b)(2)?
3. Whether the position of the United States was unreasonable under section 7430(c)(2)(A)(i)?
4. Whether Phillips is entitled to recover all of his litigation costs under section 7430(a)?

Holding

1. Yes, because Phillips prevailed on the most significant issue and the entire amount in controversy.
2. Yes, because the issue arose after the notice of deficiency was issued, and Phillips attempted to negotiate with the IRS.
3. Yes, because the IRS's position was arbitrary in light of its own revenue rulings.
4. No, because Phillips is not entitled to recover costs attributable to his own failure to file timely returns, though he may recover costs related to the IRS's unreasonable positions.

Court's Reasoning

The court applied section 7430, which allows recovery of litigation costs if the taxpayer substantially prevails and the IRS's position was unreasonable. The court found that Phillips prevailed on the only issue presented – his entitlement to file joint returns. The IRS's position was unreasonable because it relied on a Tax Court decision (Durovic) while ignoring its own revenue rulings that supported Phillips's position. The court noted that the IRS should not litigate against its own published rulings without first modifying or withdrawing them. However, the court limited Phillips's recovery to costs related to the IRS's unreasonable positions, excluding costs resulting from his own delinquency in not filing returns. The court cited legislative history indicating that section 7430 is meant to compensate taxpayers for unnecessary litigation costs, not to penalize the IRS. The dissenting opinions argued that the IRS's position was not unreasonable given the prior Tax Court decisions and that revenue rulings do not constitute binding authority.

Practical Implications

This decision clarifies that taxpayers may recover litigation costs from the IRS when the agency takes an unreasonable position, even if the taxpayer's own actions contributed to the litigation. However, such recovery may be limited to costs directly attributable to the IRS's unreasonable stance. Practitioners should be aware that the IRS's failure to follow its own revenue rulings may be considered unreasonable, potentially entitling clients to cost recovery. Conversely, taxpayers' own delinquencies may limit their recovery. This case also highlights the importance of exhausting administrative remedies, though the court noted exceptions when issues arise post-notice of deficiency. Subsequent cases have applied this ruling, with courts sometimes limiting cost recovery based on the taxpayer's own actions or finding the IRS's position reasonable despite conflicting revenue rulings.