Sher v. Commissioner, 88 T. C. 115 (1987)

The IRS's position is considered 'substantially justified' if it is reasonable, even if not correct, precluding an award of litigation costs to the prevailing party.

Summary

In Sher v. Commissioner, the Tax Court denied the petitioners' motion for litigation costs despite their prevailing in the dispute over reported income from A. G. Edwards & Sons, Inc. The case involved the IRS issuing a notice of deficiency after petitioners failed to report certain dividend and interest income. After petitioners contested the deficiency, the IRS eventually settled in their favor upon discovering the income was attributable to a defined benefit plan. The court held that the IRS's position was 'substantially justified' under the amended section 7430, and thus, petitioners were not entitled to litigation costs. The decision clarified that only actions or inactions by the IRS District Counsel and subsequent administrative actions are considered in determining if the IRS's position was substantially justified.

Facts

On October 23, 1985, petitioners received an IRS examination report indicating unreported income from A. G. Edwards & Sons, Inc. , and other sources. Petitioners contested the findings via a letter on November 7, 1985. Despite this, the IRS issued a statutory notice of deficiency on December 19, 1985. Petitioners, unable to resolve the issue administratively, filed a petition with the Tax Court on March 21, 1986. After further review, it was discovered that the unreported income was attributed to Mr. Sher's Defined Benefit Plan, leading to a settlement in favor of petitioners. Petitioners then moved for litigation costs, which was the subject of this case.

Procedural History

The Tax Court received petitioners' motion for litigation costs following their successful contest of the IRS's deficiency notice. The IRS objected to the motion. The court reviewed the record and affidavits without the need for a hearing, ultimately denying petitioners' motion for costs.

Issue(s)

1. Whether the position of the United States was not substantially justified under section 7430(c)(2)(A)(i).
2. Whether petitioners substantially prevailed in the litigation under section 7430(c)(2)(A)(ii).
3. Whether petitioners' net worth did not exceed $2,000,000 at the time the adjudication was initiated under section 7430(c)(2)(A)(iii).
4. Whether petitioners exhausted their administrative remedies within the IRS under section 7430(b)(1).

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Holding

1. No, because the IRS's position was substantially justified as it was reasonable based on the information available to the IRS District Counsel.
2. Yes, because petitioners successfully contested the deficiency notice.
3. Not addressed, as the court's decision rested on the first issue.
4. Not addressed, as the court's decision rested on the first issue.

Court's Reasoning

The court applied the 'substantially justified' standard from section 7430(c)(2)(A)(i), which replaced the former 'unreasonable' standard. The court clarified that this standard is essentially one of reasonableness, as per the legislative history and prior judicial interpretations. The court focused on the actions of the IRS District Counsel, as per section 7430(c)(4), which limits the review to actions or inactions by the District Counsel and subsequent administrative actions. The court found the IRS's position reasonable because it acted promptly upon receiving new information that resolved the dispute. The court emphasized that the IRS's position was based on the information available to it, and the absence of petitioners' letter from the IRS's file further justified the IRS's actions. The court also noted that petitioners bore the burden of proof to show the IRS's determination was incorrect.

Practical Implications

This decision impacts how attorneys should approach requests for litigation costs in tax disputes. It underscores that the IRS's position need only be 'substantially justified,' which equates to a reasonableness standard, to avoid paying litigation costs. Practitioners should ensure they exhaust all administrative remedies before litigation and must be prepared to show the IRS's position was unreasonable, not just incorrect. This ruling may encourage taxpayers to more thoroughly document and pursue administrative remedies before resorting to litigation, as the court will not consider pre-litigation actions by the IRS unless District Counsel was involved. Subsequent cases have followed this interpretation, affecting how litigants strategize and negotiate settlements in tax disputes.

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