Kennedy v. Commissioner, 89 T. C. 98 (1987)

The IRS’s position in litigation is deemed unreasonable when it attempts to change a taxpayer’s accounting method without sufficient legal or factual basis.

Summary

In Kennedy v. Commissioner, the IRS changed the petitioners’ accounting method from cash to accrual during a Taxpayer Compliance Measurement Program examination, resulting in significant adjustments to their income. The petitioners, dairy farmers who consistently used the cash method, contested this change and ultimately settled the case using the cash method. The Tax Court ruled that the petitioners were entitled to litigation costs because the IRS’s position was unreasonable, as the petitioners were permitted to use the cash method under IRS regulations and had used it consistently. The decision highlights the importance of adhering to established accounting methods and the consequences of unreasonable IRS actions in litigation.

Facts

The petitioners, Roy C. Kennedy, Sr. , and others, were dairy farmers who used the cash method of accounting. In November 1982, the IRS began a Taxpayer Compliance Measurement Program (TCMP) examination of their dairy business activities. The IRS determined adjustments to their income based on changing their accounting method from cash to accrual. Notices of deficiency were issued in December 1984, and after settlement, the parties agreed to use the cash method, resulting in significantly reduced deficiencies or overpayments for the petitioners.

Procedural History

The petitioners filed motions for an award of litigation costs under section 7430 of the Internal Revenue Code. The cases were consolidated on the petitioners’ motion due to common issues of fact and law. The Tax Court heard arguments on whether the petitioners exhausted their administrative remedies and whether the IRS’s position was unreasonable. The court ultimately ruled in favor of the petitioners, granting them litigation costs up to the statutory limit of $25,000.

Issue(s)

1. Whether the petitioners exhausted their administrative remedies within the meaning of section 7430(b)(2).
2. Whether the position of the United States in the litigation of these cases was unreasonable under section 7430(c)(2)(A)(i).

Holding

1. Yes, because the petitioners consented to one extension of the statute of

limitations and reasonably refused further extensions after two years of examination, they exhausted their administrative remedies.
2. Yes, because the IRS's change of the petitioners' accounting method from cash to accrual was unreasonable, as the petitioners were permitted to use the cash method and had done so consistently.

Court's Reasoning

The court applied the rule from Minahan v. Commissioner that a taxpayer's refusal to consent to an extension of the statute of limitations is not per se a failure to exhaust administrative remedies. The petitioners' refusal to extend further was deemed reasonable given the duration of the examination. On the issue of the IRS's position, the court noted that farmers are explicitly permitted to use the cash method of accounting under IRS regulations (Sec. 1. 471-6(a), Income Tax Regs.). The petitioners had properly elected and consistently used the cash method, and the IRS's attempt to change this method was unsupported by law or fact. The court emphasized that the IRS cannot change a taxpayer's accounting method merely to secure more tax revenue if the method clearly reflects income and is used consistently. The court also rejected the IRS's argument that the petitioners were engaged in a separate business of selling cattle, which would require inventory accounting, finding it unsupported by fact or law.

Practical Implications

This decision reinforces the importance of taxpayers' rights to use the accounting methods permitted by IRS regulations and established case law. It highlights the potential for recovery of litigation costs when the IRS's position is deemed unreasonable, particularly when attempting to change a taxpayer's accounting method without sufficient justification. Practitioners should be aware of the need to challenge such IRS actions and the potential for cost recovery under section 7430. The ruling may also influence IRS behavior in similar cases, encouraging more careful consideration of taxpayers' established accounting methods before attempting changes. Subsequent cases applying or distinguishing Kennedy include those involving the reasonableness of IRS positions in litigation and the application of section 7430.