Mearkle v. Commissioner, 838 F. 2d 880 (6th Cir. 1988)

The IRS's reliance on a proposed regulation can be deemed unreasonable if it knew or should have known the regulation was invalid, affecting the award of litigation costs to prevailing parties.

Summary

In Mearkle v. Commissioner, the Sixth Circuit held that the IRS's reliance on a proposed regulation disallowing home office deductions was unreasonable, entitling the taxpayers to litigation costs under section 7430. The case involved a $149 tax deficiency related to an Amway business operated from home. After the Tax Court initially denied costs due to the reasonableness of the IRS's position, the Sixth Circuit reversed, finding the IRS should have known the regulation was invalid. On remand, the Tax Court awarded reduced litigation costs, excluding fees incurred after the IRS's concession offer, due to the taxpayers' unreasonable protraction of the proceedings.

Facts

The IRS issued a notice of deficiency to the Mearkles for $149, disallowing their home office deduction based on a proposed regulation. The Mearkles operated an Amway business from their home. The Tax Court's decision in Scott v. Commissioner invalidated the regulation. Post-Scott, the IRS offered to concede the case, but the Mearkles refused without an admission of error, leading to further litigation. The Mearkles sought litigation costs, initially denied by the Tax Court but later reversed by the Sixth Circuit on appeal.

Procedural History

The Tax Court initially denied the Mearkles' motion for litigation costs, finding the IRS's reliance on the proposed regulation reasonable. On appeal, the Sixth Circuit reversed, holding the IRS's reliance unreasonable and remanded for a determination of reasonable litigation costs. Upon remand, the Tax Court awarded reduced litigation costs, considering the Mearkles' refusal to accept the IRS's concession as an unreasonable protraction of proceedings.

Issue(s)

1. Whether the IRS's reliance on the proposed regulation regarding home office deductions was unreasonable?
2. Whether the Mearkles were entitled to litigation costs under section 7430, and if so, what amount was reasonable?

Holding

1. Yes, because the Sixth Circuit determined that the IRS knew or should have

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known the proposed regulation was invalid.
2. Yes, but with a reduced amount, because the Mearkles unreasonably protracted the proceedings by refusing the IRS's concession offer.

Court's Reasoning

The Sixth Circuit found the IRS's reliance on the proposed regulation unreasonable because it should have been aware of its invalidity after Scott v. Commissioner. The Tax Court, on remand, applied section 7430 to award litigation costs but reduced the amount due to the Mearkles' refusal to accept the IRS's concession. The court used a $75 hourly rate for attorney fees, as suggested by amendments to section 7430, and excluded fees incurred after the IRS's offer to concede. The court also expressed concern over the high fees sought relative to the small deficiency and noted the fees were partially for the benefit of other Amway distributors.

Practical Implications

This decision impacts how courts assess the reasonableness of IRS actions based on proposed regulations, potentially encouraging quicker concessions in similar situations. It also clarifies that litigation costs may be reduced if a prevailing party unreasonably protracts proceedings. For attorneys, this case underscores the importance of promptly accepting concessions and the need to justify fees in relation to the amount in controversy. Businesses and taxpayers should be aware of the potential for reduced cost awards if they seek broader concessions or admissions from the IRS. Subsequent cases have cited Mearkle to address the reasonableness of IRS positions and the calculation of litigation costs.

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