

***James H. Swanson and Josephine A. Swanson v. Commissioner of Internal Revenue, 106 T. C. 76 (1996)***

The IRS's litigation position must be substantially justified; otherwise, taxpayers may recover reasonable litigation costs if they prevail.

**Summary**

James and Josephine Swanson challenged IRS determinations regarding their use of a DISC, FSC, and IRAs to defer income, and the sale of their residence to a trust. The Tax Court ruled that the IRS was not substantially justified in its position on the DISC and FSC issues, allowing the Swansons to recover litigation costs. However, the IRS was justified in challenging the residence sale as a sham transaction. The court also clarified that net worth for litigation cost eligibility is based on asset acquisition cost, not fair market value, and that the Swansons had exhausted administrative remedies without a 30-day letter being issued.

**Facts**

James Swanson organized a domestic international sales corporation (DISC) and a foreign sales corporation (FSC), with shares owned by individual retirement accounts (IRAs). The DISC and FSC paid dividends to the IRAs, which the IRS claimed were prohibited transactions under IRC § 4975, thus disqualifying the IRAs. Additionally, the Swansons sold their Illinois residence to a trust benefiting their corporation before a change in tax law that would eliminate favorable capital gain treatment. The IRS argued this was a sham transaction. The Swansons filed a motion for litigation costs after the IRS conceded these issues.

**Procedural History**

The IRS issued a notice of deficiency on June 29, 1992, determining tax deficiencies for 1986, 1988, 1989, and 1990. The Swansons filed a petition in the U. S. Tax Court on September 21, 1992. They moved for partial summary judgment on the DISC and FSC issues, which the IRS did not oppose. The IRS later conceded the residence sale issue. The Swansons then filed a motion for reasonable litigation costs, which led to the court vacating a prior decision and considering the costs motion.

**Issue(s)**

1. Whether the IRS's litigation position regarding the DISC and FSC issues was substantially justified.
2. Whether the IRS's litigation position regarding the residence sale as a sham transaction was substantially justified.
3. Whether the Swansons met the net worth requirement for litigation cost eligibility under IRC § 7430.
4. Whether the Swansons exhausted administrative remedies within the IRS.
5. Whether the Swansons unreasonably protracted the proceedings.

6. Whether the litigation costs sought by the Swansons were reasonable.

## **Holding**

1. No, because the IRS misapplied IRC § 4975 to the Swansons' use of the DISC and FSC, as there was no prohibited transaction.
2. Yes, because the IRS had a reasonable basis to challenge the residence sale given the Swansons' continued use and the transaction's questionable business purpose.
3. Yes, because the Swansons' net worth, calculated based on asset acquisition costs, did not exceed \$2 million when they filed their petition.
4. Yes, because the Swansons did not receive a 30-day letter and were not offered an Appeals Office conference.
5. No, the Swansons did not unreasonably protract the proceedings.
6. No, the amount sought was not reasonable and must be adjusted to reflect the record.

## **Court's Reasoning**

The court found the IRS's position on the DISC and FSC issues unreasonable because there was no sale or exchange of property between a plan and a disqualified person under IRC § 4975(c)(1)(A), and the payment of dividends to the IRAs did not constitute self-dealing under § 4975(c)(1)(E). The IRS's continued pursuit of these issues despite their lack of legal and factual basis was not justified. Regarding the residence sale, the court considered factors such as continued use and questionable business purpose as reasonable grounds for the IRS's challenge. The court also clarified that net worth for litigation cost eligibility under IRC § 7430 should be based on asset acquisition costs, not fair market value, and that the Swansons met this requirement. The court found that the Swansons had exhausted administrative remedies due to the absence of a 30-day letter and the IRS's failure to offer an Appeals Office conference. The court rejected the IRS's argument that the Swansons unreasonably protracted the proceedings. Finally, the court determined that the Swansons' requested litigation costs were not reasonable and must be adjusted based on the record.

## **Practical Implications**

This decision underscores the importance of the IRS having a reasonable basis for its litigation positions. Taxpayers can recover litigation costs when the IRS's position is not substantially justified, emphasizing the need for the IRS to carefully evaluate its arguments. The case also clarifies that net worth for litigation cost eligibility is based on acquisition cost, which may affect future eligibility determinations. Furthermore, the ruling that a lack of a 30-day letter and no offer of an Appeals Office conference constitutes exhaustion of administrative remedies may impact how taxpayers pursue litigation costs. For similar cases, practitioners should scrutinize IRS positions for substantial justification and ensure they meet the net worth requirement based on acquisition costs. Subsequent cases may cite Swanson for

guidance on litigation costs and IRS justification.