Division 16
Taxation
Of The District of Columbia Bar

Steering Committee:
Jane C. Bergner
Chair
Ronald D. Abramson
Jeanna M. Cullins
Collette C. Goodman
Leonard J. Henzke, Jr.
Bradley M. Seltzer
James E. Viach

Committees:
Business Related Taxes
Employee Benefits
Estate Planning/Death Related Taxes
Exempt Organizations
Tax Audits & Litigation
Tax Legislation, Rulings and Regulations

November 26, 1985

Joseph K. Dowley, Esquire
Chief Counsel
House Committee on Ways and Means
House Office Building
Washington, D.C. 20515

Re: Comments of D.C. Bar Taxation Division on Code Section 7430 -- Attorney Fees

Dear Mr. Dowley:

The purpose of this letter is to provide the views of the Taxation Division of the District of Columbia Bar1/ on the attorneys fees provisions which are part of the Senate version of the Budget Reconciliation Act.2/ It is our understanding that the Ways and Means Committee is considering these provisions in preparation for a likely conference with the Senate on this legislation. We urge that the House conferees support inclusion of these provisions in this legislation.

1/ STANDARD DISCLAIMER:

The views expressed herein represent only those of Division 16, Taxation, of the District of Columbia Bar and not those of the entire District of Columbia Bar or its Board of Governors. The Division of Taxation is composed of approximately 1,153 members.

2/ These provisions are identical to S. 1513, a copy of which is attached.

I. Summary of Current Statutory Provisions

The two principal statutes which currently govern attorneys fee awards are the Equal Access to Justice Act and Section 7430 of the Internal Revenue Code. While Section 7430 is the specific statute now applicable to federal tax cases, the background of the Equal Access to Justice Act is also relevant to the Committee's deliberations.

Under the general rules of American jurisprudence, attorney's fees are not awarded to the party that prevails in litigation. Recognizing that the expenses of attorney's fees and other litigation costs could unfairly affect persons who litigate against the United States, Congress enacted the Equal Access to Justice Act in 1980. In particular, Congress was concerned that individuals, businesses, and non-profit organizations of modest means might be deterred from seeking relief from unreasonable Government actions because of the high costs involved.

A. Equal Access to Justice Act

The Equal Access to Justice Act ("EAJA"), Title II of Public Law 96-481, took effect on October 1, 1981, and has applied to cases pending on or filed after that date and prior to October 1, 1984. The statute was extended permanently by P.L. 99-80, 99 Stat. 183, which became law on August 5, 1985. (See 5 U.S.C. § 504; 28 U.S.C. § 2412 (as amended).) EAJA provides for an award of attorney's fees to parties who prevail in civil actions

brought by or against the United States. Under the Act, a court shall award to the prevailing party certain attorney's fees and other expenses, unless the court finds that the position of the United States was "substantially justified" or that special circumstances make an award unjust. The position of the United States will be "substantially justified" if the United States had a reasonable basis, both in law and in fact, for proceeding in a particular case. The burden of proof is on the United States.

It is important to note that the provisions of EAJA apply only to actions in courts of the United States as defined in 28 U.S.C. 451. This definition does not include the Tax Court, and under Section 291(e) of TEFRA, EAJA cannot apply to any case as to which I.R.C. Section 7430 applies.

B. Section 7430 of the Internal Revenue Code

Because EAJA did not reach the bulk of tax litigation, in 1982 Congress enacted Section 7430 of the Code. This statute provides for the award of attorney's fees and reasonable litigation expenses3/ in actions brought by or against the United States involving the determination, collection, or refund of any tax, interest, or penalty in a court of the United States, including the Tax Court. The new rules of Section 7430 apply to

---

3/ Reasonable litigation expenses include court costs, expert witness fees, and the cost of studies or analyses necessary for the preparation of the case to the prevailing party (other than the United States).

litigation begun after February 28, 1983. Detailed Regulations interpreting this statute were issued on April 16, 1984. Treas. Reg. § 301.7430-1.

Section 7430 and EAJA differ in several respects, three of the more significant of which are as follows:

1. In order to recover fees under Section 7430, a prevailing taxpayer must establish that the position of the Government was unreasonable. The burden of proof is on the taxpayer. In contrast, under EAJA, the burden of proof is on the Government. EAJA provides that the court shall award attorneys fees to a prevailing private litigant unless the court finds that the Government's position was substantially justified or that special circumstances would make the award unjust.

2. Under Section 7430, it is unclear whether the "position" of the Government that is to be tested for reasonableness includes the position of the Internal Revenue Service that led to the litigation, or only the position taken by the Government in the litigation itself. In contrast, under EAJA, the "position" that must be substantially justified includes any agency action that led to the litigation.

3. Under Section 7430, awards are limited to $25,000. In contrast, under EAJA, hourly rates are limited to $75, but no other dollar limitation is imposed upon the amount that may be awarded.

II. Position of the Division of Taxation

A. Summary

The Division of Taxation of the D.C. Bar urges the Ways and Means Committee to follow the action of the Senate Finance Committee, by incorporating the EAJA position on the five issues enunciated below into amendments to Section 7430 of the Code.

First, while the taxpayer in normal circumstances should continue to bear the burden of proof on the substantive tax issues, once the taxpayer has prevailed, the Government should bear the burden of proving that its position was substantially justified -- viz., reasonable. The Government should logically be assigned this burden, because (1) at this point in the litigation its position has already been held to be erroneous, and (2) the Government uniquely has the evidence and arguments to demonstrate that is position was reasonable. Assigning this burden of proof to the Government should expedite the processing of attorneys fees issues in tax cases because it will implicitly allow the courts to severely restrict post-trial taxpayer discovery of the Service's administrative processes. Placing the burden of proof on the Government on the attorneys fees issue is no more burdensome than the currently analogous practices of placing the burden on the Government respecting its affirmative

defenses (statute of limitations, etc.), and shifting the burden of proof to the Government where its administrative position has been held to be arbitrary.

Secondly, we urge that the Section 7430 adopt the EAJA approach, and allow a portion of the administrative proceedings before the Service to be taken into account both in determining whether the Service's position was unreasonable and in determining the amount of any attorneys fees award. It is not fair for the Service and the Justice Department to present an unreasonable position throughout multiple administrative and judicial proceedings, and then to avoide a fee award by a last minute change in position in the litigation. This last-minute change cannot possibly erase an unreasonable position which has been held for a significant period of time. On the other hand, we also recognize that attorneys' fees and other costs incurred by taxpayers to assist tax investigatory proceedings should not be reimbursable, because at the early points in its administrative proceedings the Service has only a tentative, or investigative tax position.

We would draw the line between investigatory proceedings and proceedings in which the Service asserts a non-tentative position at the point when a taxpayer minimally exhausts administrative

remedies under the Section 7430 Regulations. Attorneys fees and costs incurred beyond that point should be subject to reimbursement under Section 7430.

Third, our judgment is that such a statute would not be hard to administer. When the Government prevails, no attorneys fees hearings would be required since no awards are allowed. In most of the remaining cases, no post-minimum exhaustion proceedings will have taken place at the Service level. Moreover, the courts frequently review parts of the administrative proceedings in tax cases, and the limited review of a few proceedings to determine attorney fee awards would not appear to be novel or burdensome to the federal couts.

Fourth, we submit that Section 7430 should provide reimbursement at the rate of $75 per hour, with no maximum. Past experience under this standard in EAJA suggests that the bill would cost only about $1 million per year. However, in order not to unduly burden the Service, we urge that only $5,000 per award be taken from the Service's budget, while the remainder of such award could be payable from the judgment fund.

Finally, we do not believe that attorneys fees legislation will discourage settlements. Indeed, settlements would be encouraged because of the attorneys fee requirement that administrative remedies be exhausted.

B. Detailed Discussion

1. Burden of Proof

Section 7430 should place the burden of proof on the Government to demonstrate that its position was substantially justified. The Government is the party which has in its possession all of the factual information relative to the question of the reasonableness of its position. Normally it will have reasoned memoranda of its staff discussing why it has taken a litigating position. The Government also has unique information about the pendency of other cases involving the same issue, both in the administrative process and in trial and other courts, and these are often material to the reasonableness of its position. Finally, the Government has readily available information about the precedential importance of a particular position, both from the standpoint of legal consistency and of revenue impact, and such information may also be relevant to the reasonableness of its position in the attorneys fee proceeding.

By contrast, the taxpayer normally has little information about the reasonableness of the Government's position, other than any inherent problems or inconsistencies in the Government's legal argument or administrative actions in the particular case. To place on the taxpayer the burden of showing the Government's unreasonableness would be equivalent to putting the burden of proof on the Government in a deduction case, where virtually all the facts are in the possession or knowledge of the taxpayer.

If taxpayers are forced to bear the burden of proving the Government's unreasonableness, the courts will be under great pressure to allow taxpayers broad discovery access to the Government's workpapers, work product, audit selection criteria, etc. If the statute places the burden of proof on the Government, Service officials can then decide for themselves what materials they wish to release to prove the reasonableness of their position. However, unless such Service documents are incomplete or demonstrate internal inconsistency on their face, or other extraordinary circumstances, a taxpayer should not be allowed further discovery of Government documents. In addition, except in extraordinary circumstances a taxpayer should not be permitted to obtain oral testimony, either by way of deposition or in court, from Service officials where such testimony solely relates to the attorneys fee issue.

Placing the burden on the Government to demonstrate the reasonableness of its position, after the court has ruled in favor of the taxpayer, does not represent any change from traditional burden of proof rules in tax cases because the taxpayer still would have the burden of proof in the entire litigation respecting determination of tax liability. Moreover, even under current law, the Government has the burden of proof on a wide range of procedural issues, such as where it raises affirmative defenses, (e.g., collateral estoppel, res judicata or

accord and satisfaction. (Tax Court Rule 36(b)). Similarly, the Commissioner has the burden of proof on any new matter which he places in issue (Tax Court Rule 142(a)); on the civil fraud penalty (I.R.C. § 6653); on transferee liability (Moran v. Commissioner, 45 T.C. 528 (1966)); and in certain accumulated earnings tax cases (I.R.C. § 534).

Indeed, in any case where the Commissioner's notice of deficiency is arbitrary, the Tax Court may already shift the burden of proof to the Commissioner. Where an opinion has already been issued finding error in the Commissioner's position, it hardly seems novel or unfair to place on the Commissioner the burden of demonstrating that that position was reasonable.

2. Definition of the Government's Position

We also urge the Committee to adopt and clarify the position taken in the Finance Committee bill regarding the scope and definition of the "position" of the Government which is to be tested for reasonableness in an attorneys fee proceeding. To date, some courts have held that the Government's "position" only encompasses the legal and factual arguments made by it in the litigation itself, while other courts have held that such "position" includes all (or some) of the legal and factual arguments and positions asserted by the Government during administrative proceedings which preceded or accompanied the litigation.

Under the Senate bill, the Government's "position" would include "the position taken by the United States in the civil proceeding", and "the administrative action or inaction by the United States upon which such proceeding is based." This provision would have an effect on a determination of both whether a liability with respect to attorneys fees exists at all, and, if so, the amount of such liability.

With respect to the fact of liability, the Government should not be permitted to take an unreasonable position through both the entire lengthy administrative proceedings and part of the litigation, and then avoid attorneys fees by changing its position late in the litigation. By taking an unreasonable position in the administrative and early litigative stages, the Government will have required a taxpayer to incur substantial attorneys fees. It is not fair to such a taxpayer for the Government to be allowed to avoid such fees by a last-minute change of position in the late stages of litigation.

On the other hand, we recognize that audits of taxpayers are usually conducted at their early stage by Service personnel who do not have legal or accounting degrees, and who may have limited experience, generally, or in the area under investigation in particular. Formulation of the Government's position in a case is not instant, but is a process involving investigation, legal research, receipt of data, preliminary reports, internal review,

and oral hearings. A considerable amount of work must usually be done before there exists a nontentative Government position. While a taxpayer will almost always incur legal or accounting fees during these initial Service activities, the activities themselves have more of an investigative, rather than an assessment, character. Our system does not generally require the Government to reimburse costs incurred by citizens in responding to Government investigations, and I.R.S. investigations should be no exception.

However, there is a point in the Internal Revenue Service administrative process when the issues have passed through the investigatory stage and a Government position has emerged. We think that this point is described, in various tax administrative contexts, by the current Treasury Regulations under Code Section 7430. These Regulations set forth the minimum administrative remedies which a taxpayer must exhaust in order for attorneys fees to be awarded. For example, in the typical case a taxpayer must generally go through the process at least up to and including the appeals conference in order to exhaust the taxpayer's administrative remedies. Treas. Regs. § 301.7430-1(b).

Of course, taxpayers may find it necessary or advantageous to participate in further administrative proceedings. For example, the taxpayer may seek reconsideration by the National

Office, or may pay the tax and file a detailed claim for refund, or do both. Under our recommendation, attorneys fees and other allowable costs incurred in such post-exhaustion taxpayer filings could be reimbursed by court awards if the Government continues to maintain an unreasonable position. But attorneys fees and costs incurred in exhausting administrative remedies, as defined by the Section 7430 Regulations, would not be reimbursable.

We believe that reasonable attorneys fees and other costs incurred by a taxpayer to participate in such administrative processes, after the Government's position has been formulated, should be reimbursable to the same extent that attorneys fees and other costs incurred in litigation would be reimbursable. The trial judge would review and approve the costs incurred in the administrative proceedings in the same manner as litigation fees and costs are reviewed. For example, a trial judge could disallow fees for taxpayer activities in administrative proceedings which were unreasonable or excessive. On the other hand, the same trial judge could allow costs incurred for reasonable and necessary post-exhaustion administrative processes, including, for example, studies or analyses submitted in such administrative proceedings. In such a context, the examination of administrative proceedings which the statute would entail should not be burdensome for the courts. Most importantly, as we have pointed out earlier, such a review would

be required only if a taxpayer had prevailed, and then only after the court's opinion had been filed. No proceedings to obtain attorneys fees should be permitted before the opinion is filed.

In addition, as a matter of practice, in the vast majority of cases, no attorneys fees or other costs would be allowable respecting administrative proceedings, because most taxpayers will have only participated in the minimum proceedings necessary to exhaust administrative remedies, for which no attorneys fees or other costs would be allowable.

In a few cases, the courts would be required to examine administrative proceedings to determine the extent of reimbursable attorneys fees and costs. However, such an examination should not be a novel or revolutionary practice. In federal tax litigation, courts frequently are required to adjudicate issues involving I.R.S. administrative proceedings -- e.g., the effect of settlement and closing agreements (Forms 870, 870-AD, etc.); the nature and effect of agreements regarding statutes of limitations; issues involving the content and meaning of records of administrative proceedings in tax exemption cases; the effect of rulings, determination letters, and technical advice memoranda on tax litigation, etc. Examination by the courts of administrative proceedings in order to determine the reasonableness of the Government's position, and the amount (if

any) of reimbursable attorneys fees and costs, is no different or more difficult than examination of all the other commonly litigated administrative questions.

The advantages of awarding pre-litigation costs must be weighed against any burden on the courts. In Finney v. Roddy, E.D. Va., Civ. 83-0686 R, Oct. 23, 1985, the District Court held that pre-litigation attorneys fees and costs are allowable because:

> The result reached here is, in the Court's view, buttressed by the conclusion that it represents basic fairness. * * *
>
> * * * the Government does not take issue with plaintiff's characterization of the IRS's conduct prior to plaintiff's filing her complaint as "unreasonable," and the Court agrees. Further, the IRS's unreasonable pre-litigation conduct plainly generated this lawsuit, along with its corresponding expenses to the plaintiff.

3. Computation of Attorneys Fees Awards

We also urge the Committee to remove from Section 7430 the current arbitrary $25,000 limit on fee awards. The $75-per-hour standard of EAJA, without any maximum dollar award figure, is a more flexible provision, and is better suited to the widely varying circumstances of federal tax cases.

Testimony before the Committee by the Commissioner last April showed that awards under EAJA have been lower, on the average, than awards under Section 7430.4/ While the data base for these statistics was very small, there is no evidence that the EAJA standard will result in excessive attorneys fees awards. Indeed, under other attorneys fees statutes with fee standards similar to EAJA, it is common knowledge that federal judges have been very strict in reviewing fee applications and disapproving unnecessary or excessive claimed hours and costs.

Since much of tax litigation tends to be repetitive in nature, and the Tax Court judges have great experience and expertise, it can be expected that the courts will be able to monitor fee applications more effectively under this statute than under other attorneys fees statutes. Based on past experience under EAJA and Section 7430, it appears that the budgetary costs of this provision will be modest -- in the area of $1 million per year. It is expected that Service reviewers will become more adept at spotting and correcting potential award cases as their experience under the statute grows. Of course, the overwhelming volume of tax cases involve protesters and abusive tax shelters, which will never even give rise to the attorneys fees question because the Government will prevail on the merits.

4/ EAJA awards have averaged $4,926, Section 7430 awards have averaged $7,037.

Nevertheless, we recognize that there is some chance that the dollar volume of fees awards could increase sharply. As tax practitioners, we are concerned about the adverse effects of a large volume of awards if they were reimbursed solely from the operating budget of the Internal Revenue Service. That agency already has critical resource shortages which are adversely affecting fair and effective tax administration.

Accordingly, we recommend that only a portion of fee awards be paid from the Service budget, with the remainder paid from the judgment fund. For example, the first $5,000 of each award might be payable from the Service's budget, while the remainder of the award could be payable from the judgment fund. Such a plan would give Service officials an incentive to prevent unreasonable administrative positions, while minimizing the potential drain on agency resources. To insure added flexibility, perhaps the legislation could contain language authorizing the Secretary of the Treasury to adjust the ratio of each award payable by the Service and by the judgment fund, if written approval is first obtained from the Chairs of the Senate Finance and House Ways and Means Committees.

To further moderate any adverse affects on the revenues, we suggest incorporating into Section 7430 the net worth limitations in EAJA on the parties who are eligible to obtain fee reimbursement. See P.L. 99-80, Sec. 2(d), amending 28 U.S.C. §

2412(d)(2)(B). In general, this would exclude individuals with a net worth of over $2 million, or entities with a net worth of over $7 million, from obtaining attorneys fee reimbursement. However, all Section 501(c)(3) charities and Section 521 cooperatives would qualify for such fees.

4. Fee Awards Will Not Discourage Settlements

There is no basis for concluding that providing for attorneys fee awards in tax cases will increase litigation. Quite the contrary, it may increase settlements since taxpayers will be required to participate in administrative proceedings, rather than simply filing suit immediately. Participation in these proceedings will unquestionably result in many settlements. Without an attorneys fee statute, and faced with limited client resources, attorneys often bypass the administrative proceedings and file suit immediately in the belief that litigation is the best way to use the funds available. Under Section 7430, an attorney faced with an unreasonable I.R.S. position could spend his client's dollars in the administrative process, knowing that if the mistake was not corrected there the client would have a good chance of obtaining reimbursement for litigation costs and possibly a portion of administrative costs.

CONCLUSION

We believe that incorporation of the basic elements of EAJA into Section 7430, as outlined above, will have a beneficial effect on tax administration generally. Our tax system ultimately rests on taxpayer satisfaction that it is administered in a fair and even-handed manner, and that mistakes by Government personnel are subject to redress either administratively or in the courts. If the attorneys fee provisions applicable in tax cases are in principal more disadvantageous and difficult for the taxpayer than the provisions applicable to non-tax cases, the confidence of citizens in the basic integrity of the tax system will be diminished. The occasional view that the Service can injure taxpayers with impunity would be encouraged if it alone is exempted from the basic principles of EAJA applicable to other agencies. By fairly redressing the occasional erroneous treatment of a taxpayer in the administrative process, Section 7430 will ultimately benefit the entire tax system.

Please do not hestitate to contact the chair, or one of the members of the Steering Committee, if you have any questions.

Respectfully submitted,

Leonard J. Henzke, Jr.

STEERING COMMITTEE
DIVISION OF TAXATION
(DIVISION 16)
DISTRICT OF COLUMBIA BAR