New Tax Court Case Explores Boundaries of "Qualified Offers" to the IRS

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I. Introduction

The Internal Revenue Service ("IRS") sometimes utilizes intimidation and aggressive tactics in an effort to convince taxpayers to concede cases without significant resistance. Unbeknownst to many taxpayers, they have a powerful tool for evening the proverbial playing field with the IRS: making a so-called "Qualified Offer." The basic notion is that if the IRS ignores or rejects a Qualified Offer, the case goes to trial, and the court ultimately rules that the taxpayer's liability is the same as or less than the amount in the earlier Qualified Offer, then the taxpayer may recoup reasonable fees and costs from the IRS. That is correct; under certain circumstances, taxpayers can not only claim victory on substantive issues in a tax dispute, but also make the IRS pay, literally and figuratively, for its insistence on pressing matters forward. This article describes the general rules for seeking fee recoupment with the IRS under Code Sec. 7430, explains the unique standards applicable to Qualified Offers, and analyzes a recent Tax Court case, *G.C. Lewis*, which establishes new parameters for Qualified Offers.[1]

II. Recouping Costs from the IRS

Code Sec. 7430 generally provides that the "prevailing party" in any administrative proceeding or litigation with the IRS related to the determination, collection, or refund of any tax, penalty, or interest may be awarded reasonable administrative and/or litigation costs.[2] Recoverable administrative costs may include legal fees, expenses for expert witnesses, and costs for any study, analysis, report, test, or project necessary for preparing a case.[3] Litigation costs for which the taxpayer may seek reimbursement follow similar guidelines.[4] Various aspects of Code Sec. 7430 are explained below.

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A. Congressional Purpose

According to the legislative history, the objective of Congress in enacting Code Sec. 7430 was to "deter abusive actions or overreaching by the [IRS] and … enable individual taxpayers to vindicate their rights regardless of their economic circumstances."[5]

B. Prevailing Party Standards

The term "prevailing party" generally means a party in any tax-related administrative proceeding or litigation that (i) has substantially prevailed with respect to either the amount in dispute or the most significant issues presented, and (ii) has a net worth below the statutory thresholds.[6]

C. Exhausting Administrative Remedies

Even if a taxpayer substantially prevails and meets the net worth requirement, he still cannot recover costs from the IRS unless he overcomes other hurdles. One such barrier is that the taxpayer must have exhausted all administrative remedies available within the IRS.[7] In a Chief Counsel Advice noteworthy for its muddled reasoning, the IRS indicated that a taxpayer must try all solutions, regardless of the theory under which he is seeking cost recoupment.[8] This mandate does not obligate the taxpayer to grant the IRS extensions of the assessment period.[9]

D. No Unreasonable Delays

Another hurdle for preserving eligibility for fee recoupment is that the taxpayer cannot "unreasonably protract" proceedings with the IRS.[10]

E. Substantial Justification for IRS Positions

Yet another impediment to fee recovery is that the taxpayer will not be deemed the "prevailing party" if the IRS can establish that its position was "substantially justified."[11] In other words, if the IRS manages to prove that the legal and tax theories that it advanced during the administrative dispute or litigation were substantially justified, this precludes the taxpayer from recovering costs, even when he prevails regarding the amount and/or issues in play. Understanding what constitutes a "substantial justification," therefore, is paramount.

Until 1996, the burden was on the taxpayer to demonstrate that the IRS's position was *not* substantially justified. This radically changed with the enactment of the Taxpayer Bill of Rights 2, which shifted the onus to the IRS.[12] According to congressional reports, "the successful taxpayer will receive an award of attorney's fees unless the IRS satisfies its burden of proof."[13] This legislation introduced another major change; it required the IRS to follow its published guidance to the general public, as well as its private guidance to particular taxpayers.[14]

Congress further advanced the issue in favor of taxpayers in 1998 with the passage of the Taxpayer Bill of Rights 3.[15] This legislation empowered the courts to take into account whether the IRS has lost on similar issues in appellate courts for other circuits in determining whether its position is substantially justified.[16] The relevant reports show the purpose for this increased pressure: Congress was concerned that the IRS would continue to litigate issues that had been previously decided in other circuits.[17] This brand of stubbornness, claim the reports, would place an undue burden on those taxpayers forced to dispute decided issues.[18]

The legislative modifications discussed above have been incorporated into the Internal Revenue Code and corresponding regulations. The general rule still stands that a taxpayer will not be a "prevailing party," and thus will not be entitled to reimbursement, if the IRS's position was substantially justified.[19] However, there is now a rebuttable presumption that the IRS's position was *not* substantially justified if the IRS failed to follow its "applicable published guidance" during a dispute.[20] Such guidance includes temporary or final regulations, revenue rulings, information releases, notices, and announcements.[21] It also encompasses various items issued to the particular taxpayer involved in a dispute, such as private letter rulings, technical advice memoranda, and determination letters.[22] In deciding whether an IRS position was substantially justified, the courts must consider whether IRS has already lost on similar issues in federal courts of appeal.[23]

The regulations provide additional clarity regarding what constitutes a substantial justification. They explain, for instance, that the IRS's position is substantially justified only if it has a reasonable basis in both fact and law.[24] A significant factor in making this determination is whether the taxpayer presented all the relevant information under his control to the appropriate IRS personnel.[25]

Along with the legislative history and the regulations, case law is helpful in identifying what represents substantial justification. Certain courts have developed a framework, a non-exhaustive list of factors to scrutinize. Among these factors are (i) the stage at which the issue or litigation is resolved, (ii) the opinions of other courts on the same issues, (iii) the legal merits of the IRS's position, (iv) the clarity of the governing law, (v) the

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foreseeable length and complexity of the litigation, and (vi) the consistency of the IRS's position.[26] Other courts have utilized a different approach, analyzing whether the position taken by the IRS was reasonable.[27] These courts hold that a position is substantially justified if it is "justified to a reasonable degree that could satisfy a reasonable person or that has a reasonable basis in both law and fact."[28] Still other courts rely on a different test, presenting the key question as to whether the IRS knew or should have known that its position was invalid at the time it took it.[29]

III. Qualified Offers

To summarize the preceding segment of this article, a taxpayer ordinarily will be considered the prevailing party, and thus might be entitled to cost reimbursement, if he substantially prevails with respect to the amount in dispute or the most significant issues, has a net worth below the applicable limit, demonstrates that the IRS's position was not substantially justified, participates in all administrative remedies available, and does not unreasonably extend the proceedings. There is another way for taxpayers to obligate the IRS to pay; that is, making a so-called "Qualified Offer."

A. General Rule and Main Exceptions

A taxpayer ordinarily is treated as the prevailing party if his liability, as determined by a court judgment, is the same as or less than what the liability would have been if the IRS had just accepted his Qualified Offer in the first place.[30] Exceptions exist, of course. The Qualified Offer rule does not apply, for instance, to a proceeding in which the amount of the tax liability is not an issue, such as court actions to obtain a Declaratory Judgment, enforce or quash a summons, *etc.*[31]

The Qualified Offer rule is also inapplicable where the parties settle the case before a court issues its judgment.[32] Stated differently, taxpayers can only recoup fees from the IRS if they make a Qualified Offer, the IRS ignores or rejects it, and the case is resolved later through litigation, with the court issuing a decision. Thus, making a Qualified Offer might convince the IRS to re-evaluate the strength of its position and agree to a pre-trial settlement. In such circumstances, the taxpayer would enjoy a lower tax liability, but not fee recoupment, too.[33]

The regulations raise another interesting issue, which is what occurs where there is a judicial determination on a substantive tax issue, followed by a settlement by the parties. This would happen, for example, where a court grants a Motion for Partial Summary Judgment resolving a tax issued covered by a Qualified Offer, but leaves open a key matter, such as valuation. The Preamble to the regulations provides the following guidance for these situations:

> [I]f one or more adjustments covered by a Qualified Offer are settled following a ruling by the court that substantially resolves those adjustments, then those adjustments will ***not*** be treated as having been settled prior to the entry of the judgment by the court and ***instead*** will be treated as amounts included in the judgment as a result of the court's determinations.[34]

B. Making Multiple Qualified Offers

If a taxpayer makes more than one Qualified Offer during a dispute, then the analysis is based on the last Qualified Offer, and the bills do not start accumulating against the IRS until after the date of the last Qualified Offer.[35]

C. Criteria for Qualified Offers

This all begs the question of what, exactly, is a Qualified Offer? Generally, it is a (i) written offer, (ii) made by the taxpayer, (iii) to the IRS, (iv) during the "Qualified Offer period," (v) which specifies the amount offered, by stating either a precise dollar amount or a percentage of the proposed adjustments at issue, (vi) is properly designated as a Qualified Offer, and (vii) remains open for acceptance by the IRS during a period that begins when it is made, and ends on the date that the IRS rejects the offer, the date that the trial starts, or 90 days after the taxpayer makes the offer, whichever is earliest.[36]

> *The facts and issues in G.C. Lewis were unique, but the case still makes a noteworthy contribution to the broader, evolving guidance regarding Qualified Offers.*

Certain requirements are more lax when it comes to fee recoupment under the Qualified Offer rule. Specifically, a taxpayer who is deemed the prevailing party because he made a Qualified Offer does not need to prevail regarding

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the amount in dispute or the most significant issues, and whether the IRS's positions during the audit, administrative appeal, or litigation were substantially justified is irrelevant.[37]

D. Directing Matters to the Right Person

When engaged in a dispute against the IRS, a Qualified Offer ordinarily is made when it is delivered to the office or personnel within the IRS, Appeals Office, or Office of Chief Counsel who or that has jurisdiction over the tax matters at issue in the dispute.[38] The regulations contemplate alternative places to deliver a Qualified Offer, if the taxpayer is unaware of the IRS office or personnel with jurisdiction over the dispute.[39]

E. Period During Which Qualified Offers Can Be Made

The "Qualified Offer period" starts the date on which the "first letter of proposed deficiency which allows the taxpayer an opportunity for administrative review" with the IRS Appeals Office is sent, and ends 30 days before the date on which the case is first set for trial.[40]

F. Size of the Qualified Offer

The Qualified Offer rules do not demand a minimum amount, do not define the size of a reasonable offer, do not mandate that an offer be for a certain percentage of the proposed liability, *etc.* Consequently, when taxpayers are confident that they ultimately will convince a court that their liability is $0 or they are due a refund, taxpayers can make a Qualified Offer consisting of merely $1 and still recoup fees from the IRS.[41]

IV. New Case Setting Parameters

A recent Tax Court case, *G.C. Lewis*, illustrates the functioning and limitations of Code Sec. 7430 and Qualified Offers.[42]

A. Summary of Relevant Facts

Wife and her Ex-Husband filed joint Forms 1040 (*U.S. Individual Income Tax Returns*) for 2008, 2009, and 2010. The IRS audited such returns and issued an Examination Report indicating that the couple owed additional taxes and penalties. The Revenue Agent and Wife discussed her potential eligibility for "innocent spouse relief" during the audit, but she never supplied a Form 8857 (*Request for Innocent Spouse Relief*) or any supporting materials.

Later, Wife sent what she labeled a Qualified Offer to the IRS, stating that she would concede 100 percent of the taxes and penalties for all three years, as set forth in the Examination Report, and would agree to immediate assessment by the IRS of such amounts ("Settlement Proposal"). However, the Settlement Proposal explicitly stated that it constituted an offer regarding assessment, not payment. It went on to explain that Wife reserved "all collection rights" for which she qualifies, including, among other things, the right to subsequently claim innocent spouse relief under Code Sec. 6015. The IRS did not accept or reject the Settlement Proposal; it simply allowed it to lapse.

The IRS then issued a Notice of Deficiency, identifying both Wife and Ex-Husband as individuals jointly liable for additional taxes and penalties for the three relevant years. Wife filed a timely Petition, and later an Amended Petition, disputing the Notice of Deficiency and alleging her entitlement to innocent spouse relief. The IRS filed an Answer with the Tax Court in which it admitted that Wife requested relief and indicated that it would make a determination regarding her eligibility for such relief. Ex-Husband filed a separate Petition with the Tax Court and then intervened in Wife's case, thereby bringing all issues and parties together.

The IRS attorney handling the case repeatedly asked Wife to submit Form 8857 or supply other information to support her claim for innocent spouse relief. She did not. Nevertheless, the IRS attorney referred the case to the centralized innocent spouse relief office, which again requested that Wife provide Form 8857 and supporting materials. She did not.

Surprisingly, after resolving the Tax Court case with Ex-Husband, the IRS concluded that Wife was entitled to innocent spouse relief. Consistent with this determination, the IRS attorney asked Wife to execute a Stipulation of Settled Issues or a Decision Document, confirming that she owed $0 to the IRS. Wife refused to execute these items, thus triggering an impasse. The IRS attorney, in an effort to advance matters, filed a Motion for Entry of Decision, asking the Tax Court to end the case by issuing a Decision Document showing that the Wife had a liability of $0 for all three years thanks to innocent spouse relief. The IRS attorney also submitted to the Tax Court a Notice of Concession acknowledging that Wife should benefit from innocent spouse relief. Wife, unwavering, objected to both IRS filings, calling them a "litigation tactic" aimed at preventing the IRS from paying her fees under Code Sec. 7430. Wife eventually filed a Motion for Litigation Costs, which the IRS opposed.

B. Two Theories for Fee Recoupment

Wife demanded payment of legal fees and other costs from the IRS based on two theories. First, she sought financial vindication on grounds that she supposedly filed

a Qualified Offer, the IRS ignored it, and the case was ultimately resolved on terms equal to, or more favorable than, those contained in her Qualified Offer. Second, she argued that she was the "prevailing party," and the IRS's position was not "substantially justified." Both contentions are examined below.

1. Qualified Offer Theory

The IRS urged the Tax Court to decide that the Settlement Proposal was not really a Qualified Offer because it did not meet all the criteria set forth in Code Sec. 7430 and the corresponding regulations. Specifically, the IRS maintained that the Settlement Proposal did not indicate an amount "the acceptance of which by the [IRS] will fully resolve the taxpayer's liability." The IRS underscored that Wife merely conceded assessment of taxes and penalties, but reserved the right to challenge such assessment later by raising innocent spouse relief.

Wife disagreed, of course. Her take was that (i) she stated in the Settlement Proposal her willingness to accept assessment of 100 percent of the taxes and penalties described in the Examination Report and (ii) her ultimate liability in the case (*without* taking into account innocent spouse relief) was less than if the IRS had accepted her Settlement Proposal. Why should the Tax Court ignore the effect of innocent spouse relief? Wife presented some convoluted reasoning on this point, suggesting that innocent spouse relief should not be a factor because she did not officially allege such relief until two years after making the Settlement Proposal, when she filed her Amended Petition with the Tax Court. Wife added that, at the time she submitted the Settlement Proposal with the language about reserving "all collection rights," she did not know if she would ever file a request for innocent spouse relief because Ex-Husband had the financial wherewithal to pay the entire liability. The Tax Court noted that Wife supplied "no legal basis" for her request for the Tax Court to ignore the financial impact of her receiving innocent spouse relief.

The Tax Court explained that the issue of whether the Settlement Proposal constituted a Qualified Offer depends on whether Wife's reserving the right to claim innocent spouse relief relates to tax "collection," as she tried to characterize it, or to the underlying tax liability. The Tax Court emphasized that the text of Code Sec. 6015 itself answers the question in favor of the IRS. Citing several aspects of the provision, the Tax Court underscored that innocent spouse relief, as established by Code Sec. 6015, "relieves a taxpayer from liability for tax, not just the collection of tax." Next, the Tax Court highlighted that spousal defenses, including innocent spouse relief, are separate from collection-based alternatives for challenging proposed seizures and liens by the IRS. The Tax Court went on to clarify that taxpayers who file joint Forms 1040 with spouses, like Wife, have the right to raise innocent spouse relief as an affirmative defense to the liability when they first file a Petition with the Tax Court. Finally, the Tax Court highlighted that, if the IRS were to reject an administrative claim for innocent spouse relief by issuing a Notice of Determination, the aggrieved spouse could file a Petition with the Tax Court focused solely on that one issue.

> *However, other taxpayers, who present a specific, unconditional amount to the IRS and meet a long list of additional criteria, might achieve the Holy Grail of tax disputes: resolving matters with reduced or no tax liabilities, while sticking the IRS with the legal fees for their trouble.*

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For the reasons described above, the Tax Court held that the Settlement Proposal made by Wife "flunks the requirement" that a Qualified Offer specify either a precise dollar amount or a percentage of the proposed adjustments at issue. This is because the amount that Wife was offering necessarily depended on the potential future application of innocent spouse relief, which could not be determined until the IRS or the Tax Court had a chance to consider the matter. In other words, the Settlement Proposal did not contain sufficient specificity "because her tax liabilities might (and were) reduced to zero after consideration of her reserved right to claim relief from joint and several liability" with her Ex-Husband.

2. Prevailing Party Theory

As explained earlier in this article, a taxpayer ordinarily will be the prevailing party if he substantially prevails with respect to the amount in dispute or the most significant issues, has a net worth below the applicable limit, demonstrates that the IRS's position was not substantially justified, exhausts all administrative remedies available, and does not unreasonably extend the battle. In *G.C. Lewis*, the IRS conceded that Wife was victorious regarding the

amount in dispute and the most significant issues, and that she was below the net worth threshold. Moreover, no allegations surfaced about Wife failing to participate in all possible administrative procedures or unreasonably prolonging matters. The only issue for the Tax Court to decide, therefore, was whether the IRS's position was substantially justified.

In *G.C. Lewis*, the IRS acknowledged in its Answer that Wife had requested innocent spouse relief and committed itself to reviewing such request and rendering a decision. The Tax Court summarized the concept of "substantially justified" as interpreted by various courts. It also referred to the regulations under Code Sec. 7430, which indicate that a significant factor is whether the taxpayer presented "all relevant information and legal arguments" to the IRS. The Tax Court concluded that the IRS's position was substantially justified because Wife did not present all information and arguments, and the IRS's stance had a reasonable basis in both fact and law. It emphasized that a reasonable person, like the IRS, could demand that Wife provide a completed Form 8857 and other supporting documentation before making a decision about the applicability of innocent spouse relief. Lastly, the Tax Court pointed out that the IRS ultimately granted innocent spouse relief, not based on evidence provided by the Wife because "there was none," but rather on the settlement that the IRS managed to reach separately with Ex-Husband.

V. Conclusion

The facts and issues in *G.C. Lewis* were unique, but the case still makes a noteworthy contribution to the broader guidance regarding Qualified Offers. Wife, as a result of reserving the right in the Settlement Proposal to seek innocent spouse relief later, was unsuccessful in her quest. However, other taxpayers, who present a specific, unconditional amount to the IRS and meet a long list of additional criteria, might achieve the Holy Grail of tax disputes: resolving matters with reduced or no tax liabilities, while sticking the IRS with the legal fees for their trouble.

ENDNOTES

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1 *G.C. Lewis*, 158 TC —, No. 3, Dec. 62,017 (March 3, 2022). For more information about Qualified Offers in other contexts, *see* Hale E. Sheppard, *Partnerships, Making Qualified Offers, and Conservation Easement Disputes: Analyzing Problems with the IRS's Positions, Now and Later*, 22(4), JOURNAL OF TAX PRACTICE & PROCEDURE 33 (2020); Hale E. Sheppard, *Are the IRS's Positions Substantially Justified? New Cases Clarify Standards for Reimbursements to Taxpayers under Section 7430*, 135(5), JOURNAL OF TAXATION 10 (2021) and 108(1), PRACTICAL TAX STRATEGIES 4 (2022).

2 Code Sec. 7430(a). The law broadly refers to tax-related actions involving the "United States," but this article solely references the IRS for the sake of simplicity.

3 Code Sec. 7430(c)(2).

4 Code Sec. 7430(c)(1).

5 H.R. Rep. No. 97-404, 97th Cong., 1st Sess. at 11 (1981).

6 Code Sec. 7430(c)(4)(A).

7 Code Sec. 7430(b)(1).

8 Chief Counsel Advice 200919037 (May 8, 2009).

9 Code Sec. 7430(b)(1).

10 Code Sec. 7430(b)(3).

11 Code Sec. 7430(c)(4)(B)(i).

12 P.L. 104–168.

13 H.R. Rept. 104–506, 104th Cong., 2d Sess. 1996, page 37.

14 P.L. 104–168, §701; H.R. Rept. 104–506, 104th Cong., 2d Sess. 1996, pages 36–37.

15 P.L. 105–206.

16 P.L. 105–206, §3101, codified as Code Sec. 7430(c)(4)(B)(iii).

17 H.R. Rept. 105–364, 105th Cong., 1st Sess. 1997, page 58; Sen. Rept. 105–174, 105th Cong., 2d Sess., 1998, page 48.

18 H.R. Rept. 105–364, 105th Cong., 1st Sess. 1997, page 58; Sen. Rept. 105–174, 105th Cong., 2d Sess., 1998, page 48.

19 Code Sec. 7430(c)(4)(B)(i).

20 Code Sec. 7430(c)(4)(B)(ii).

21 Code Sec. 7430(c)(4)(B)(iv)(I); Reg. §301.7430-5(c)(3).

22 Code Sec. 7430(c)(4)(B)(iv)(II); Reg. §301.7430-5(c)(3).

23 Code Sec. 7430(c)(4)(B)(iii).

24 Reg. §301.7430-5(c)(1).

25 Reg. §301.7430-5(c)(1); Reg. §301.7430-5(h) Ex. 1.

26 *National Federation of Republican Assemblies*, DC-AL, 2003-1 USTC ¶50,249, 263 FSupp2d 1372, 1378 (2003).

27 *R.C. Kennedy*, 89 TC 98, Dec. 44,046 (1987) (holding that the IRS's position was unreasonable where it acted contrary to its own regulations, contrary to case law, and without factual support).

28 *Nolan R. Wilkes*, CA-11, 2002-1 USTC ¶60,438, 289 F3d 684, 688 (2002).

29 *See, e.g., M.J. Downing*, 89 TCM 1009, Dec. 55,983(M), TC Memo. 2005-73.

30 Code Sec. 7430(c)(4)(E)(i); Reg. §301.7430-7(a); Reg. §301.7430-7(b)(1); Reg. §301.7430-7(b)(2) (providing that interest is not counted, unless the taxpayer's liability for, or entitlement to, interest is a contested issue in the administrative proceeding or litigation, and is one of the issues addressed in the last Qualified Offer).

31 Code Sec. 7430(c)(4)(E)(ii); Reg. §301.7430-7(a).

32 T.D. 8922, 2001-1 CB 508 (Jan. 4, 2001), Preamble; *See also* Code Sec. 7430(c)(4)(E)(ii); Reg. §301.7430-7(a).

33 Reg. §301.7430-7(e), Example 8.

34 T.D. 9106, 2004-1 CB 384 (Dec. 24, 2003), Preamble (emphasis added). Court rulings relating to discovery, admissibility of evidence, and burden of proof are not treated as rulings that substantially resolve adjustments covered by a Qualified Offer. *Id*.

35 Code Sec. 7430(c)(4)(E)(iii).

36 Code Sec. 7430(g)(1); Reg. §301.7340-7(c)(1); Reg. §301.7430-7(c).

37 T.D. 8922, 2001-1 CB 508 (Jan. 4, 2001), Preamble (emphasis added); *See also* Reg. §301.7430-7(b)(1).

38 Reg. §301.7430-7(c)(2)(i).

39 Reg. §301.7430-7(c)(2)(i).

40 Code Sec. 7430(g)(2); Reg. §301.7430-7(c)(7); T.D. 8922, 2001-1 CB 508 (Jan. 4, 2001), Preamble.

41 *BASR Partnership*, FedCl, 2017-1 USTC ¶50,144, 130 FedCl 286 (2017), 119 AFTR 2d 2017-614.

42 *G.C. Lewis*, 158 TC —, No. 3, Dec. 62,017 (2022).

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