RECOVERY OF ATTORNEY'S FEES IN TAX CASES

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

FIRST SESSION

ON

S. 752 and S. 1673

OCTOBER 19, 1981

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RECOVERY OF ATTORNEY'S FEES IN TAX CASES

MONDAY, OCTOBER 19, 1981

U.S. SENATE,
SUBCOMMITTEE ON OVERSIGHT OF THE
INTERNAL REVENUE SERVICE,
COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice at 2:10 p.m. in room 2221, Dirksen Senate Office Building, Hon. Charles Grassley (chairman of the subcommittee) presiding.

Present: Senators Grassley and Baucus.

[The committee press release announcing this hearing; the bills S. 752, S. 1673, the description of these bills by the Joint Committee on Taxation and the prepared statements of Senators Dole and Wallop follow:]

Press Release No. 81-166

PRESS RELEASE

FOR IMMEDIATE RELEASE
September 28, 1981

COMMITTEE ON FINANCE
UNITED STATES SENATE
Subcommittee on Oversight of
the Internal Revenue Service
2227 Dirksen Senate Office Bldg.

FINANCE SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE RESCHEDULES HEARING ON RECOVERY OF ATTORNEYS' FEES IN TAX CASES

Senator Charles E. Grassley, Chairman of the Subcommittee on Oversight of the Internal Revenue Service of the Senate Committee on Finance announced today that the public hearing on recovery of attorneys' fees in tax cases, originally scheduled for October 2, 1981, will be held on Monday, October 19, 1981.

The hearing will begin at 2:00 p.m. in Room 2221 of the Dirksen Senate Office Building.

The leadoff witnesses for the hearing are expected to be The Honorable John E. Chapoton, Assistant Secretary for Tax Policy, Department of the Treasury, and The Honorable Roscoe L. Egger, Jr., Commissioner of the Internal Revenue Service.

Senator Grassley stated that the Subcommittee would particularly welcome testimony on the general topic of recovery of attorneys' fees in tax cases and specific testimony relating to S. 752, introduced by Senator Baucus, which would provide for the awarding of reasonable court costs and certain fees to prevailing parties in civil tax actions. "Senator Baucus and I have been working together on this issue, and we plan to introduce a bill next week."

DESCRIPTION OF LAW AND BILLS
RELATING TO
AWARDS OF ATTORNEY'S FEES IN TAX CASES
(Public Law 96-481, S. 752, and S. 1673)

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

This pamphlet describes legislative proposals relating to the payment of attorneys' fees to taxpayers who prevail in tax litigation against the Government. It has been prepared by the staff of the Joint Committee on Taxation in connection with a public hearing on these proposals scheduled for October 19, 1981, by the Subcommittee on Oversight of the Internal Revenue Service of the Senate Committee on Finance.

The first part of this pamphlet describes present law provisions that allow awards of attorneys' fees, in certain circumstances, in tax cases: (1) the Civil Rights Attorney's Fees Awards Act of 1976 and (2) the Equal Access to Justice Act, which provides for such awards in certain tax cases in the Federal district courts and the United States Court of Claims (as of October 1, 1981). Part one of the pamphlet also includes a discussion of some of the relevant issues with respect to the awarding of attorneys' fees in tax cases. The second part of the pamphlet contains a description of two bills that would provide, exclusively, for the award of attorneys' fees in tax cases: S. 752 (introduced by Senators Baucus, Long, Goldwater, Williams, and Leahy) and S. 1673 (introduced by Senators Baucus, Grassley, Goldwater, Williams, and Leahy).

I. BACKGROUND

A. Present Law

The Civil Rights Attorney's Fees Awards Act of 1976

The Civil Rights Attorney's Fees Awards Act of 1976 (42 U.S.C. sec. 1988) provides, in part, that in any civil action or proceeding, brought by or on behalf of the United States, to enforce, or charging a violation of, a provision of the Internal Revenue Code, the court, in its discretion, may allow the prevailing party, other than the United States, reasonable attorney's fees as part of the costs. This provision has limited applicability to tax litigation and results in very few fee awards, because it is limited to actions brought by or on behalf of the Government (that is, to cases in which the taxpayer is the defendant). Most civil tax litigation is initiated by the taxpayer who brings suit against the Government. In the United States Tax Court, the taxpayer is the petitioner in a deficiency proceeding. In the Federal district courts and the U.S. Court of Claims, the taxpayer is the plaintiff suing the Government for a refund.

The Equal Access to Justice Act

Last year, as part of Public Law 96–481, the Congress enacted the Equal Access to Justice Act (28 U.S.C. sec. 2412) which, in part, authorizes awards to a prevailing party other than the United States of fees and other expenses incurred by that party in any civil action (other than cases sounding in tort) brought by or against the United States in any court having jurisdiction of that action, unless the court finds that the position of the United States was substantially justified or that special circumstances make an award unjust. This provision applies, specifically, to cases in Federal district courts and the United States Court of Claims. However, the provision is not specifically applicable to cases in the United States Tax Court.[1]

Because this provision applies to cases in which taxpayers are plaintiffs, and not merely to cases brought by the Government, it creates a greater potential for fee awards in tax cases than does the Civil Rights Attorney's Fees Awards Act of 1976. The provision became effective on October 1, 1981, and will continue to apply through final disposition of any action commenced before October 1, 1984.

Under the Equal Access to Justice Act, fees and other expenses that may be awarded to a prevailing party include the reasonable expenses of expert witnesses, the reasonable cost of any study, analysis, engineering report, test, or project which is found by the court to be necessary for the preparation of the party's case, and reasonable attorney's

[1] This is because the Equal Access to Justice Act is contained in Title 28 of the United States Code, which deals with courts created under Article III of the United States Constitution. The United States Tax Court was established under Article I of the United States Constitution.

fees. In general, no expert witness may be compensated at a rate that exceeds the highest rate of compensation for expert witnesses paid by the United States. Attorneys' fees in excess of $75 per hour may not be awarded unless the court determines that a higher fee is justified. In general, parties who may recover fees and expenses under the Act are: (1) individuals whose net worth does not exceed $1,000,000 at the time the action is filed; (2) sole owners of an unincorporated business, partnership, corporation, association, or organization whose net worth does not exceed $5,000,000 at the time the civil action is filed (however, tax-exempt charitable organizations and certain cooperative associations are not subject to this net worth limitation); and (3) sole owners of an unincorporated business, partnership, corporation, association, or organization that has no more than 500 employees at the time the action is filed.

B. Issues

In General

Fee awards in tax cases.—The principal issue is whether taxpayers who prevail in civil tax actions should be entitled to awards for attorneys' fees. Proponents of fee awards in tax cases contend that these awards are necessary to deter abusive actions or overreaching by the Internal Revenue Service and to enable the individual taxpayer to vindicate his rights regardless of his economic circumstances. Opponents claim that fee awards in tax actions could seriously impair the administration of the tax laws. It is argued that the availability of fee awards would encourage taxpayers to litigate disputes rather than pursue administrative remedies, thereby increasing the already heavy volume of tax cases in the courts. An increase in tax litigation would generally impair the taxpayer's ability to obtain prompt resolution of a dispute. It is further argued that fee awards in tax cases are inappropriate because the taxpayer is generally not enforcing any rights beyond his own vested interest.

Specific Issues

If such awards are allowed, a number of related issues arise.

Courts having jurisdiction.—One issue is whether the provision for awards should apply in all courts having jurisdiction over tax issues. The Equal Access to Justice Act applies only to Federal district courts and the U.S. Court of Claims. Critics contend that the availability of fee awards in only these courts encourages forum shopping and makes an award depend upon the fact of whether the taxpayer paid the amount of tax at issue before suing the Government. Moreover, the majority of tax litigation occurs in the United States Tax Court. Thus, excluding the Tax Court from application of the provision would greatly restrict the payment of attorneys' fees in tax litigation generally.

Availability in administrative proceedings.—A further consideration is whether fee awards should be available in administrative proceedings. Proponents contend that unless fee awards are available at the administrative phase of a dispute between the Service and the taxpayer, taxpayers will be encouraged to bypass their administrative remedies and pursue litigation in order to obtain attorneys' fees. Critics of the availability of fee awards in administrative proceedings argue that they would add expense and complexity to the system of administrative appeals within the Internal Revenue Service which has been effective in resolving approximately 95 percent of disputes between the taxpayer and the Government without trial.

Types of tax controversies.—A related issue is the types of tax controversies or proceedings for which fee awards should be available.

It has been argued that awards should not be available in State court proceedings such as probate cases, State receiverships, assignments

for the benefit of creditors, or interpleaders where the action of the government is not discretionary. Also, it is further argued that certain declaratory judgment actions such as classification of organizations as tax-exempt, the qualification of certain retirement plans, and status of certain governmental obligations should be exempt from fee awards since, in these cases, the taxpayer is not seeking to vindicate his rights, but rather is hoping to qualify for a kind of favorable tax treatment not generally available to taxpayers without special characteristics. Others contend that the provision for fee awards can only be equitable and effective if it applies in all cases where the taxpayer opposes the Government, since the nature of the controversy, generally, does not affect the ability of the taxpayer to litigate against the Government.

Standards for award.—A significant issue in the award of attorneys' fees is the standards for determining if an award should be made. Some have argued that the court should have discretion to determine when an award is appropriate. Opponents of this standard argue that it still keeps the taxpayer at the mercy of the Government.

Others have argued that the prevailing party should be automatically entitled to an award of fees. Opponents of this standard contend that it is often difficult to determine who the prevailing party is in tax litigation, since a number of unrelated factual issues and taxable years may be involved in a case. Moreover, the Government should not necessarily be penalized for the reasonable pursuit of debatable tax issues. Tax administration would be ineffective if the Government conceded all close cases to the taxpayer in order to avoid payment of fee awards.

A third standard also has been advocated under which the prevailing party must show that the action of the Government in pursuing litigation was unreasonable. Proponents of this standard contend that this would protect the taxpayer from Government abuses and encourage responsible Government action while, at the same time, avoid the potential for a massive increase in the burden of the courts. Opponents of this standard claim that taxpayers would rarely recover because the evidence of unreasonable conduct is usually in the possession of the Government. Moreover, the taxpayer already has the burden of proving either that he is entitled to a refund or not liable for a certain amount of taxes in order to prevail in the case.

Finally, some urge that, in accordance with the standards applied under the Equal Access to Justice Act, taxpayers who prevail in tax cases should be entitled to an award of attorneys' fees unless the court finds that the position of the United States was substantially justified or that special circumstances make an award unjust.

Eligible recipients.—There is a further issue of what taxpayers should be eligible for fee awards. The Equal Access to Justice Act places income and size limitations on recipients. Proponents of these types of limitations argue that fee awards are intended to enable those taxpayers who would not otherwise be able to afford to defend their interests to litigate. It is contended that more affluent taxpayers who were awarded fees would be receiving a windfall. Opponents of these limitations contend that the taxpayer's wealth or company size should not affect the determination of whether an award is appropriate. Some advocates have proposed that the Government also be eligible for fee awards. It is argued that this would deter frivolous taxpayer suits.

Opponents contend, however, that permitting the Government to recover fees would chill all taxpayer suits including meritorious ones.

Another suggested prerequisite to eligibility for attorneys' fee awards is a requirement that taxpayers exhaust all administrative remedies prior to litigation. Proponents argue that failure to impose such a requirement would encourage taxpayers to bypass the administrative appeals process, which is one of the principal forums for the resolution of tax disputes, and would substantially increase the amount of tax litigation. Opponents of such a requirement contend that it would be burdensome to enforce. Furthermore, they feel that, in many cases, it is futile for a taxpayer to pursue administrative remedies. Others have suggested that, in order to preserve the role of pretrial administrative procedures, an award of attorneys' fees should not be allowed if the taxpayer's own failure to cooperate in a reasonable administrative investigation leaves the Government with no alternative but to litigate the tax liability.

Nature and extent of costs.—The nature and extent of costs to be recovered also should be considered. Costs of litigation may include not only attorneys' fees and court costs but also accountants' fees, expenses of expert witnesses, or the costs of studies, lab tests, engineering reports necessary for the preparation of a case, travel, clerical assistance, preparation of documents, and other related expenses. Some have argued that all of these costs should be explicitly included in any fee award provision. Others have argued that an award of these expenses may not be appropriate or reasonable in every case. They urge that the court have discretion to determine reasonable attorneys' fees and costs.

It also has been argued that the overall amount of money should be limited. Proponents of a dollar limit claim that the most complex and sophisticated tax issues and, thus, the most costly are generally raised by more affluent individuals and corporations. In addition, a dollar limit might encourage early settlements in docketed cases. Therefore, in order to discourage excessive litigation and yet assure relief to taxpayers with limited resources, it is argued that a ceiling on the amount of the award is appropriate. Critics of a ceiling argue that the wealth of the taxpayer should not affect the determination of whether a taxpayer should be reimbursed for the costs of litigation. They urge that the determination be based on an evaluation of the facts of each case, rather than the characteristics of the taxpayer.

Temporary or permanent provision.—A final issue to be considered is whether a provision authorizing the award of attorneys' fees in tax cases should be permanent. Since fee awards do constitute a departure from the usual procedure in the American judicial system where, generally, litigants bear their own costs, some have urged that attorney's fee legislation expire after a number of years. Proponents of a sunset provision argue that it would afford administrators, legislators, and practitioners an opportunity to assess the effects of the legislation. The Equal Access to Justice Act, itself, has a sunset date of October 1, 1984. Opponents of a sunset provision argue that permanent fee award legislation is necessary to deter abusive Government action and enable taxpayers to defend their interests. Moreover, critics contend that it could create difficult transitional problems for cases pending on the sunset date.

II. DESCRIPTION OF BILLS

S. 752 (Senator Baucus, *et al.*) and S. 1673 (Senators Baucus, Grassley, *et al.*)

Taxpayer Protection and Reimbursement Act

Explanation of Provisions

In general

The bills would provide for the award of reasonable court costs to prevailing parties in civil tax actions. Specifically, court costs could be awarded in civil actions or proceedings brought by or against the United States in any United States court, including the Tax Court, for the determination, collection, or refund of any tax, interest, or penalty. Thus, parties who are plaintiffs or defendants in suits involving the determination, collection, or refund of any tax, interest, or penalty imposed by the Internal Revenue Code would be eligible for these awards. However, no award could be made to the United States or to a creditor of the taxpayer.

The bills are identical except, as noted below, with respect to the maximum amount of court costs that could be awarded.[1]

Limitations

The amount of reasonable court costs would be limited to a maximum of $20,000 by S. 752. Under S. 1673, maximum court costs would be $25,000. Under both bills, awards would be allowed only to the extent that costs were allocable to the United States and not to any other party to the action or proceeding.

Reasonable court costs

Under the bills, reasonable court costs would include (1) the reasonable expenses of expert witnesses, (2) the reasonable cost of any study, analysis, engineering report, test, or project that is found by the court to be necessary for the preparation of the party's case, and (3) reasonable fees paid or incurred for the services of attorneys. In the case of Tax Court proceedings, fees for the services of an individual (whether or not an attorney) who is authorized to practice before the Tax Court would be treated as fees for the services of an attorney.

Prevailing party

The bills provide guidelines for determining who is a prevailing party, for purposes of awarding court costs. A prevailing party would be a party (other than the United States or a creditor of the taxpayer involved) who (1) establishes that the position of the United States in the civil action or proceeding was unreasonable, and (2) has sub-

[1] A hearing was held on a similar bill (H.R. 3262) on September 28, 1981, by the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means.

stantially prevailed with respect to the amount in controversy or has substantially prevailed with respect to the most significant issue, or set of issues, presented.

The determination of who is a prevailing party would be made either by the court or by agreement of the parties.

Excluded actions

The bills would exclude certain civil actions and proceedings from those eligible for awards. The excluded actions would be:

(1) Declaratory judgments with respect to the status and classification of organizations as tax-exempt organizations, qualified charitable donees, private foundations, or private operating foundations (unless the action or proceeding involves the revocation of the tax-exempt status of a charitable organization);

(2) Declaratory judgments with respect to the initial or continuing qualification of certain retirement plans;

(3) Declaratory judgments with respect to whether a transfer of property from a United States person to a foreign corporation has the avoidance of Federal income taxes as one of its principal purposes; and

(4) Declaratory judgments with respect to the status of certain governmental obligations for purposes of the income tax exclusion for interest under Code section 103(a).

The bills would make their new Code provision for awards of court costs the exclusive provision for such awards in any tax cases to which this new provision applies. Thus, taxpayers would have to seek such awards for costs in tax litigation under new Code section 7430 and would be denied awards under the Equal Access to Justice Act and the Civil Rights Attorney's Fees Awards Act of 1976.

Multiple actions

The bills would require that multiple actions which could have been joined or consolidated, and a case or cases involving a return or returns of the same taxpayer (including a married couple's joint returns) which could have been joined in a single proceeding in the same court, generally must be treated as a single action or proceeding, whether or not joined or consolidated for purposes of awarding court costs. However, if the court determines that it would be inappropriate to treat such cases as joined or consolidated, for purposes of awarding court costs, awards may be determined for the cases separately.

Right of appeal

An order granting or denying an award would be incorporated as part of the court's decision or judgment. The order would be appealable in the same manner, and to the same extent, as the decision or judgment.

Source of awards

Payments of awards would be made from the funds of the Government agency involved in the action or proceeding.

Effective Date

The bills would apply to civil actions and proceedings filed after December 31, 1980, and before January 1, 1991.

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II

97TH CONGRESS
1ST SESSION

S. 752

To amend the Internal Revenue Code of 1954 to provide for the awarding of reasonable court costs and certain fees to prevailing parties in civil tax actions, and for other purposes.

IN THE SENATE OF THE UNITED STATES

MARCH 19 (legislative day, FEBRUARY 16), 1981

Mr. BAUCUS (for himself, Mr. LONG, Mr. GOLDWATER, Mr. WILLIAMS, and Mr. LEAHY) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to provide for the awarding of reasonable court costs and certain fees to prevailing parties in civil tax actions, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Taxpayer Protection and Reimbursement Act".

SEC. 2. AWARDING OF COSTS AND CERTAIN FEES.

(a) IN GENERAL.—Subchapter B of chapter 76 of the Internal Revenue Code of 1954 (relating to proceedings by taxpayers and third parties) is amended by redesignating section 7430 as section 7431 and by inserting after section 7429 the following new section:

"SEC. 7430. AWARDING OF COURT COSTS AND CERTAIN FEES.

"(a) IN GENERAL.—In the case of any civil action or proceeding which is—

"(1) brought by or against the United States for the determination, collection, or refund of any tax, interest, or penalty under this title, and

"(2) brought in a court of the United States (including the Tax Court),

the prevailing party may be awarded a judgment for reasonable court costs incurred in such action or proceeding.

"(b) LIMITATIONS.—

"(1) MAXIMUM DOLLAR AMOUNT.—The amount of reasonable court costs which may be awarded under subsection (a) with respect to any prevailing party in any civil action or proceeding shall not exceed $20,000.

"(2) ONLY COSTS ALLOCABLE TO THE UNITED STATES.—An award under subsection (a) shall be made only for reasonable court costs which are alloca-

ble to the United States and not to any other party to the action or proceeding.

"(c) DEFINITIONS.—For purposes of this section—

"(1) REASONABLE COURT COSTS.—

"(A) IN GENERAL.—The term 'reasonable court costs' includes the reasonable expenses of expert witnesses, the reasonable cost of any study, analysis, engineering report, test, or project which is found by the court to be necessary for the preparation of the party's case, and reasonable fees paid or incurred for the services of attorneys.

"(B) ATTORNEY'S FEES.—In the case of any proceeding in the Tax Court, fees for the services of an individual (whether or not an attorney) who is authorized to practice before the Tax Court shall be treated as fees for the services of an attorney.

"(2) PREVAILING PARTY.—

"(A) IN GENERAL.—The term 'prevailing party' means any party to any action or proceeding described in subsection (a) (other than the United States or any creditor of the taxpayer involved) which—

"(i) establishes that the position of the United States in the civil action or proceeding was unreasonable, and

"(ii)(I) has substantially prevailed with respect to the amount in controversy, or

"(II) has substantially prevailed with respect to the most significant issue or set of issues presented.

"(B) DETERMINATION AS TO PREVAILING PARTY.—Any determination under subparagraph (A) as to whether a party is a prevailing party shall be made—

"(i) by the court, or

"(ii) by agreement of the parties.

"(d) EXCLUSION OF CERTAIN CIVIL ACTIONS OR PROCEEDINGS.—No award for reasonable court costs may be made under subsection (a) with respect to any civil action or proceeding brought under—

"(1) section 7428 (relating to declaratory judgments with respect to status and classification of organizations under section 501(c)(3), etc.), unless such action or proceeding involves the revocation of the tax-exempt status of an organization described in section 501(c)(3),

"(2) section 7476 (relating to declaratory judgments with respect to qualification of certain retirement plans),

"(3) section 7477 (relating to declaratory judgments with respect to transfers of property from the United States), or

"(4) section 7478 (relating to declaratory judgments with respect to status of certain governmental obligations).

"(e) MULTIPLE ACTIONS.—For purposes of this section, in the case of—

"(1) multiple actions which could have been joined or consolidated, or

"(2) a case or cases involving a return or returns of the same taxpayer (including joint returns of married individuals) which could have been joined in a single proceeding in the same court,

such actions or cases shall be treated as one civil action or proceeding regardless of whether such joinder or consolidation actually occurs, unless the court in which such action or proceeding is brought determines, in its discretion, that it would be inappropriate to treat such actions or cases as joined or consolidated for purposes of this section.

"(f) RIGHT OF APPEAL.—An order granting or denying an award for reasonable court costs under subsection (a), in

whole or in part, shall be incorporated as a part of the decision or judgment in the case and shall be subject to appeal in the same manner and to the same extent as the decision or judgment.

"(g) SOURCE OF PAYMENT.—Payment of any award for reasonable court costs under subsection (a) shall be made by the agency over which the party prevails from any funds made available to the agency, by appropriation or otherwise, for such purpose.".

(b) APPLICATION WITH TITLE 28.—Section 2412 of title 28, United States Code, is amended by adding at the end thereof the following new subsection:

"(e) The provisions of this section shall not apply to any costs, fees, and other expenses in connection with any action or proceeding to which section 7430 of the Internal Revenue Code of 1954 applies.".

(c) CONFORMING AMENDMENTS.—

(1) The table of sections for subchapter B of chapter 76 of such Code is amended by striking out the item relating to section 7430 and inserting the following new items:

"Sec. 7430. Awarding of court costs and certain fees.
"Sec. 7431. Cross references.".

(2) Section 722 of the Revised Statutes (42 U.S.C. 1988) is amended by striking out immediately after "Public Law 92-318" the clause "or in any civil

action or proceeding, by or on behalf of the United States of America, to enforce, or charging a violation of, the United States Internal Revenue Code,".

SEC. 3. EFFECTIVE DATE.

The amendments made by this title shall apply to civil actions or proceedings filed after December 31, 1980, and before January 1, 1991.

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II

97TH CONGRESS
1ST SESSION

S. 1673

To amend the Internal Revenue Code of 1954 to provide for the awarding of reasonable court costs and certain fees to prevailing parties in civil tax actions, and for other purposes.

IN THE SENATE OF THE UNITED STATES

SEPTEMBER 28 (legislative day, SEPTEMBER 9), 1981

Mr. BAUCUS (for himself, Mr. GRASSLEY, Mr. GOLDWATER, Mr. WILLIAMS, and Mr. LEAHY) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to provide for the awarding of reasonable court costs and certain fees to prevailing parties in civil tax actions, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Taxpayer Protection and Reimbursement Act".

★(Star Print)

SEC. 2. AWARDING OF COSTS AND CERTAIN FEES.

(a) IN GENERAL.—Subchapter B of chapter 76 of the Internal Revenue Code of 1954 (relating to proceedings by taxpayers and third parties) is amended by redesignating section 7430 as section 7431 and by inserting after section 7429 the following new section:

"SEC. 7430. AWARDING OF COURT COSTS AND CERTAIN FEES.

"(a) IN GENERAL.—In the case of any civil action or proceeding which is—

"(1) brought by or against the United States for the determination, collection, or refund of any tax, interest, or penalty under this title, and

"(2) brought in a court of the United States (including the Tax Court),

the prevailing party may be awarded a judgment for reasonable court costs incurred in such action or proceeding.

"(b) LIMITATIONS.—

"(1) MAXIMUM DOLLAR AMOUNT.—The amount of reasonable court costs which may be awarded under subsection (a) with respect to any prevailing party in any civil action or proceeding shall not exceed $25,000.

"(2) ONLY COSTS ALLOCABLE TO THE UNITED STATES.—An award under subsection (a) shall be made only for reasonable court costs which are alloca-

ble to the United States and not to any other party to the action or proceeding.

"(c) DEFINITIONS.—For purposes of this section—

"(1) REASONABLE COURT COSTS.—

"(A) IN GENERAL.—The term 'reasonable court costs' includes the reasonable expenses of expert witnesses, the reasonable cost of any study, analysis, engineering report, test, or project which is found by the court to be necessary for the preparation of the party's case, and reasonable fees paid or incurred for the services of attorneys.

"(B) ATTORNEY'S FEES.—In the case of any proceeding in the Tax Court, fees for the services of an individual (whether or not an attorney) who is authorized to practice before the Tax Court shall be treated as fees for the services of an attorney.

"(2) PREVAILING PARTY.—

"(A) IN GENERAL.—The term 'prevailing party' means any party to any action or proceeding described in subsection (a) (other than the United States or any creditor of the taxpayer involved) which—

"(i) establishes that the position of the United States in the civil action or proceeding was unreasonable, and

"(ii)(I) has substantially prevailed with respect to the amount in controversy, or

"(II) has substantially prevailed with respect to the most significant issue or set of issues presented.

"(B) DETERMINATION AS TO PREVAILING PARTY.—Any determination under subparagraph (A) as to whether a party is a prevailing party shall be made—

"(i) by the court, or

"(ii) by agreement of the parties.

"(d) EXCLUSION OF CERTAIN CIVIL ACTIONS OR PROCEEDINGS.—No award for reasonable court costs may be made under subsection (a) with respect to any civil action or proceeding brought under—

"(1) section 7428 (relating to declaratory judgments with respect to status and classification of organizations under section 501(c)(3), etc.), unless such action or proceeding involves the revocation of the tax-exempt status of an organization described in section 501(c)(3),

"(2) section 7476 (relating to declaratory judgments with respect to qualification of certain retirement plans),

"(3) section 7477 (relating to declaratory judgments with respect to transfers of property from the United States), or

"(4) section 7478 (relating to declaratory judgments with respect to status of certain governmental obligations).

"(e) MULTIPLE ACTIONS.—For purposes of this section, in the case of—

"(1) multiple actions which could have been joined or consolidated, or

"(2) a case or cases involving a return or returns of the same taxpayer (including joint returns of married individuals) which could have been joined in a single proceeding in the same court,

such actions or cases shall be treated as one civil action or proceeding regardless of whether such joinder or consolidation actually occurs, unless the court in which such action or proceeding is brought determines, in its discretion, that it would be inappropriate to treat such actions or cases as joined or consolidated for purposes of this section.

"(f) RIGHT OF APPEAL.—An order granting or denying an award for reasonable court costs under subsection (a), in

whole or in part, shall be incorporated as a part of the decision or judgment in the case and shall be subject to appeal in the same manner and to the same extent as the decision or judgment.

"(g) SOURCE OF PAYMENT.—Payment of any award for reasonable court costs under subsection (a) shall be made by the agency over which the party prevails from any funds made available to the agency, by appropriation or otherwise, for such purpose.".

(b) APPLICATION WITH TITLE 28.—Section 2412 of title 28, United States Code, is amended by adding at the end thereof the following new subsection:

"(e) The provisions of this section shall not apply to any costs, fees, and other expenses in connection with any action or proceeding to which section 7430 of the Internal Revenue Code of 1954 applies.".

(c) CONFORMING AMENDMENTS.—

(1) The table of sections for subchapter B of chapter 76 of such Code is amended by striking out the item relating to section 7430 and inserting the following new items:

"Sec. 7430. Awarding of court costs and certain fees.
"Sec. 7431. Cross references.".

(2) Section 722 of the Revised Statutes (42 U.S.C. 1988) is amended by striking out immediately after "Public Law 92-318" the clause "or in any civil

action or proceeding, by or on behalf of the United States of America, to enforce, or charging a violation of, the United States Internal Revenue Code,".

SEC. 3. EFFECTIVE DATE.

The amendments made by this title shall apply to civil actions or proceedings filed after December 31, 1980, and before January 1, 1991.

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STATEMENT OF SENATOR DOLE

We are here today to receive public comment on legislation relating to the recovery of attorney's fees in tax court litigation.

The history of American civil litigation generally is that each party should bear the economic burden of vindicating his individual rights. However, because of the great societal benefit directly and indirectly derived from certain civil actions, Congress has provided some exceptions to the rule to allow the recovery of attorney's fees from the losing party.

The Civil Rights Attorney's Fees Act of 1976 allows the court to award attorney's fees to the prevailing party in any civil action or proceeding brought by or on behalf of the United States, to enforce or to charge a violation of a provision of the Internal Revenue Code. This provision is limited to actions brought by or on behalf of the Government and, therefore, has limited applicability to tax litigation.

Last year, as part of the Equal Access to Justice Act, Public Law 96-481, the Congress enacted legislation which generally authorizes the award of attorney's fees and other expenses to certain prevailing parties in civil actions brought by or against the United States, unless the court finds that the position of the United States was substantially justified, of special circumstances would make an award unjust. This provision only applies to tax cases brought in the Federal district court and the U.S. Court of Claims. Tax cases brought in the U.S. Tax Court were specifically excluded in order to allow the tax writing committees of Congress time to enact separate legislation concerning these cases.

The revenue laws enacted by Congress are administered and enforced by the Government to the best of its ability. We have all heard of controversies between the Internal Revenue Service and taxpayers where the Government may have overstepped its bounds and caused taxpayers to spend great amounts of time, energy, and money to vindicate their rights under the revenue laws. The purpose of this hearing is to receive public comment on legislation, S. 752 and S. 1673, which provides that the Government pay the attorney's fees and certain other costs of prevailing taxpayers incurred in litigating a tax dispute in Tax Court where the Government has overstepped its bounds in enforcing the revenue laws.

I look forward to hearing the views of the public on the merits of this legislation.

STATEMENT OF SENATOR MALCOLM WALLOP, CHAIRMAN, SENATE SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION

Today's hearing is for the purpose of receiving public and Administration comment on two bills before the Senate concerning energy conservation tax credits. In opening this hearing, I would like to take a few moments to coment on energy conservation tax credits, and more specifically, S. 750, the "Industrial Energy Security Tax Incentives Act of 1981."

As you are probably aware, energy conservation tax credits have been a hot topic of debate not only in Washington, but across the country. Following the President's recent address to the nation the Administration announced that the elimination of energy conservation tax credits was one area under review as a possible "revenue enhancer." However, it did not take long for the Administration to learn what the Congress already knew—that these credits have bipartisan, nationwide support. It should have come as no surprise. There is not other factor which plays such a significant role in American economic life as energy. And while its importance has never been discounted, the role of the federal government in artificially controlling supplies as well as prices left Americans with the illusion that energy supplies would always be cheap and abundant virtually by constitutional blessing. The reality behind that illusion became all too clear in 1973 and again in 1977. This country—its economy, its people—were the captives of the "petro-politics" of the Middle East.

We have learned from those mistakes, and it has become a national priority to become energy self-sufficient. We have decontrolled oil, encouraged business to convert to coal—our greatest domestic energy resource—and we have provided programs and incentives for the development of synthetic fuel production. But there is another resource that we have barely begun to tap. Robert Stobaugh and Daniel Yergin of Harvard, in their book Energy Future called it "conservation energy." It is a source that the National Academy of Sciences' Committee on Nuclear and Alternative Energy Systems cited as having the potential of saving 5.5 million barrels of oil per day by the year 2010 in the industrial sector alone—a figure which eclipses the volume of our present oil imports.

It is unfortunate that the last Administration chose to equate energy conservation solely with sacrifice and stagnation. Adding to the already significant burden of

public misery, they preached democratized misery. In reality, energy conservation can enhance American productivity while making a significant contribution to our national security. It is a program which, if properly implemented, is consistent in every way with the present Administration's philosophy and this nation's program of economic recovery. It is not a question of doing with less, but producing more, with less energy consumption.

The question has been posed as to whether energy conservation tax credits belong in a tax code, or whether the free market should dictate what investments the industrial sector makes. You will find no stronger advocate for free market economics than me. I strongly believe, however, that the past policies of the federal government are in large part responsible for the energy problems we face today. The perceived need for interference in the past dictates that we now move quickly to adopt aggressive policies that accelerate the energy-efficient investments in plant and equipment. Investments that would have already been made had it not been for the folly of those past policies. But beyond that, there is the overriding concern which must be addressed by the Administration, and that is national security. An effective energy conservation program can make a significant contribution in shielding us from the political instability which daily threatens our principal sources of imported oil.

Even today you will hear the argument that American business must take into account the inevitability of future supply disruptions and displacements. And when things get bad enough, the business community can depend on the strategic petroleum reserve to keep the economy going. I suggest that too many roles are conceived for that reserve. It is, as its name indicates, a strategic reserve to be used in time of crisis. Further, no corporate planner can—nor is he or she expected to—anticipate when and if there will be another significant disruption in energy supplies. Energy resources can be stockpiled by business only within practical economic parameters. Common sense—business sense—dictates that limited capital will not be devoted, in significant part, to planning for contingencies.

S. 750 represents what I believe to be a creative step toward implementing a coherent, cost-effective energy policy. It is bottomed on the philosophy of demonstrated energy savings. Unlike the present credits which remind me of the old Chrysler commercial gimmick of "buy a car—get a check," S. 750 requires that energy savings must be proven if an investment is to qualify for a tax credit. And even then a full credit is not guaranteed. Should any installation achieve such a significant savings in energy that the investment should have been a priority item without the credit—the credit is proportionately reduced. On the other hand, if the energy savings are disproportionately small in relation to the amount of the investment, then the amount of tax credit which can be taken is restricted. I recognize that the 20 percent credit provided by the bill may well be too rich for the government's palate right now.

Under free market forces business has already made the easy investments in energy conservation—the so-called first tier investments. The second tier investments are of course more expensive. On business drawing boards across the country are plans for new, more efficient plants and equipment to replace those which presently exist—and certainly most of those investments will be made at some point. S. 750 is designed to get those plants into production sooner, rather than later. We must use the present energy respite to assure that the inevitable supply disruptions of the future are of minimal consequence to the American economy.

Energy policy is not, cannot simply be a function of natural resource development alone. We must make every effort to seek and implement a sound, well-balanced approach which exploits the full potential of America ingenuity as well as its resources. It is my sincere hope that the Administration will join us in developing such a program.

Senator GRASSLEY. I would like to call this hearing to order.

The topic of today's hearing is the award of attorney's fees in the Tax Court cases, and the solution to this problem offered by S. 752 and S. 1673.

During the final days of the 96th Congress, the Equal Access to Justice Act was added as an amendment to the Small Business Assistance Act. This amendment was retained in conference and became Public Law 96-481. This act provides for the payment of attorney's fees and litigation costs in civil cases brought before the Federal District Court of the U.S. Court of Appeals. Under the act,

the Court may award the prevailing party attorney's fees and other expenses when the Court finds that the position of the United States was not substantially justified or other circumstances make an award unjust.

Senator Baucus introduced a bill in the 96th Congress and another bill in the 97th extending the principles of the Equal Access to Justice Act to prevailing taxpayers in Tax Court cases. As a recognized leader on this topic, Senator Baucus kindly consented to allow me to be part of this effort. Together, we introduced S. 1673 as our latest attempt to rectify this unfair situation.

S. 1673 allows the award of attorney's fees and costs, up to $25,000 to the taxpayer in actions brought in the U.S. Tax Court, if the taxpayer can demonstrate the Government's position was unreasonable. This bill is identical to S. 752 except the amount a taxpayer may collect has been raised to $25,000. Senator Baucus and I feel this better reflects the true cost of fighting a Tax Court case.

For the purposes of discussion, I want to raise some ideas that might change this legislation. They have been drafted as amendments, but I want to reserve any judgment on whether or not to offer them. I am anxious to hear the witnesses' responses to these suggestions.

The suggested amendments are as follows:

First, an amendment requiring the Tax Court to make a determination that the taxpayer has made a reasonable effort to exhaust IRS administrative remedies before an award of attorney's fees and costs can be granted. Since approximately 95 percent of all tax disputes are resolved administratively, it seems important to discourage taxpayers from immediately litigating a claim in the Tax Court in the hopes of covering fees.

The second amendment requires the Tax Court to make a determination that the taxpayer has made a full and timely disclosure of all relevant facts before an award of attorney's fees and costs can be granted.

The third amendment would exclude the so-called "small claims" cases from this legislation. A timely and informal procedure has been established by the Tax Court to resolve "small claims" and it would be disruptive for that procedure to allow this legislation to apply to small cases. Or more accurately, I ought to ask the question, "Would it be disruptive?"

At this time, I would like to return now to my colleague, the ranking minority member of this committee, Senator Baucus, to see if he has any opening comments.

Senator BAUCUS. Thank you, Mr. Chairman. I have a statement I would like to submit for the record.

Before we continue the hearing, though, let me make a couple of observations. First, I think this bill, along with some others, is essential because IRS plays such a comprehensive role today in America's society. That role is becoming more and more comprehensive as the months and years progress due to a variety of economic circumstances. Second, we have to make such that the central underpinning of our tax collection system, voluntarism, is upheld and obtained in this bill which was designed to uphold that principle.

Third point I want to make concerns the amendments which the chairman has outlined. I think we should look at those proposed amendments—amendments that are proposed, as I understand it, by the administration or at least favored by the administration—very, very carefully, because the more we move in the direction that those amendments will take us, the more we defeat the purpose of this bill.

I look forward to the testimony of the witnesses. I am very confident that this full committee will expeditiously move the bill as appropriate for us.

[The prepared statement follows:]

STATEMENT OF SENATOR BAUCUS

The issues we are are considering today are timely and important. On October 1, 1981, the Equal Access to Justice Act came into effect, providing for payment of taxpayers' attorneys' fees in District Court and Court of Claims cases, but not in Tax Court cases. As a result, there is now an inconsistent set of rules in place which need to be rationalized and made uniform.

In addition, the Administration, the Congress and the people are demanding that all agencies of the Federal Government operate efficiently and fairly. Because the Internal Revenue Service deals directly with so many of our citizens, it is vital that taxpayers have meaningful protection against unreasonable actions by that agency.

I have introduced legislation cosponsored by Senator Grassley and others which would provide uniform, reasonable rules for recovery of attorneys' fees in all tax cases, whether they were brought in the Tax Court, in the District Court or in the Court of Claims. This legislation was introduced as S. 752 this spring and reintroduced as S. 1673 this fall with a $25,000, rather than a $20,000, fee cap.

Under this legislation, fees would be awarded to a taxpayer who prevailed in a case where the Government was unreasonable in taking a position. The legislation would not penalize the IRS or impair its performance when it acts reasonably and fairly.

Without legislation permitting awards of attorneys' fees in tax cases, taxpayers would often have to settle with the Government notwithstanding the unreasonableness of the Government's position, because the costs of litigation might exceed the tax dollars involved in the controversy. Even if the tax amounts are large enough to merit the litigation expense, the taxpayer's court victory over an unreasonable Government position does not make him whole. A significant part of the court recovery must go to pay legal expenses which the taxpayer would not have incurred had the Government been fair and reasonable. Taxpayers who lose money in this way as a result of unreasonable Government actions justifiably feel that they are not being treated fairly.

S. 752 and S. 1673 would provide such taxpayers with fair treatment. First, the legislation would ease the financial burden imposed on taxpayers who win in court against an unreasonable IRS position. Second, the legislation would discourage the IRS from forcing taxpayers to litigate against unreasonable IRS positions.

S. 752 and S. 1673 would also perform the important function of providing uniform rules for fee awards in tax cases. By failing to cover Tax Court proceedings, the Equal Access to Justice Act provides only partial relief. If a taxpayer is faced with a substantial assessment based on an unreasonable IRS position, he should be able to litigate the matter and be eligible for an award of attorneys' fess without having to bear the often substantial financial burden of paying the full assessment in order to be able to file a claim for refund in the District Court or in the Court of Claims.

Finally, by providing fair and uniform rules, this legislation would increase respect for our tax system by placing taxpayers on a more equal footing with the IRS.

I would like to welcome all the witnesses and express my appreciation to them for giving up their time to be with us today and give us the benefit of their views.

Senator GRASSLEY. Before we go to the first two witnesses, I have a copy of a statement by Chief Judge Theodore Tannebaum of the U.S. Tax Court for inclusion in the record at this point. Without objection, that will be included

[The prepared statement follows:]

Statement of Chief Judge Theodore Tannenwald, Jr.,
United States Tax Court,
on Legislative Proposals Relating to Payment of
Attorneys' Fees in Tax Litigation

Before the Subcommittee on Select
Revenue Measures,
Committee on Ways and Means,
U.S. House of Representatives
September 28, 1981

This statement is submitted in lieu of a personal appearance, on behalf of the United States Tax Court, with respect to various legislative proposals contained in House of Representatives bills relating to the payment of attorneys' fees and costs in tax litigation. Because each of these proposals, if enacted, would have an enormous impact upon the effective functioning of the Tax Court, I believe it important to bring the views of the Court to the attention of the Congress, and I would be pleased, should the Subcommittee so desire, to appear and answer questions regarding the proposed legislation.

Before I set forth the views of the Court, one preliminary observation is in order: I know that there is

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a question as to the applicability of the Equal Access to Justice Act, Pub. L. 96-481, to Tax Court litigation. Obviously, the need for, and character of, further legislation will depend upon how this question is answered. However, since this question may well be presented to the Tax Court for decision, I think it would be inappropriate for me to make any comments thereon. Rather, I think the views of the Court should be directed toward exploring the problems as if the question of awarding attorneys' fees and costs in litigation before the Tax Court was being considered de novo.

I. Should Attorneys' Fees and Costs of Litigation be Awarded by the Tax Court?

A. General

Whether the Congress should create a right to an award of attorneys' fees and costs in tax litigation is a matter involving competing considerations. Vigorous enforcement of the tax laws by the Internal Revenue Service and the Department of Justice is generally perceived as essential, not only to insure that the Federal Government collects the revenue necessary for it to function effectively, but also to discourage less conscientious taxpayers from attempting to shift part of their tax burden to others. In fact, the Congress long ago recognized the importance of the collection of the revenue by providing that, with certain limited

exceptions, no suits can be maintained to restrain the assessment or collection of any Federal tax. See section 7421, I.R.C. 1954. On the other hand, the taxpayer's right to fair and evenhanded treatment cannot and should not be denied. I am sure that everyone recognizes that these competing considerations must be carefully balanced in reaching any decision, but, as the Subcommittee's announcement of this hearing indicated, there are enormous difficulties in achieving the proper balance. Where litigation in the Tax Court is concerned, there are several extremely significant considerations which should be taken into account:

(1) The unusually large volume of litigation before the Tax Court now pending and in prospect.

(2) The fact that a very large percentage of the cases litigated before the Tax Court are settled.

(3) The presence of a small tax case procedure in the Tax Court, which Congress has constantly shown its desire to encourage and where taxpayers have been able to present their cases informally, promptly, and in person without any need for legal representation.

(4) The fact that most cases in the Tax Court, unlike other types of litigation and tax litigation in the district courts and the Court of Claims, involve a multiplicity of issues, so that the determination of entitlement to attorneys' fees and costs of litigation becomes a much more complicated

question.

(5) The increasing number of cases being brought to the Tax Court by so-called tax protestors who have sought, and continue to seek, to invalidate the application of the Internal Revenue Code to them on a variety of constitutional and other grounds which have repeatedly been determined to be without merit.

(6) Closely allied to the tax protestors are the taxpayers who simply refuse to deal with the Internal Revenue Service at any time -- whether during an attempted audit or in the preparation of a case for trial after they have filed their petitions in the Tax Court. They finally produce their records when their case is called for trial and, in effect, want the Tax Court to be the auditor. The number of taxpayers in this category has increased significantly in recent times.

It is against the background of the foregoing considerations that the Congress must reach a decision. There is no doubt that there are situations where the Internal Revenue Service has been overreaching in its audit procedures. But these situations appear to represent a very small part of the picture. When they are evaluated in the context of the considerations which I have previously set forth, serious doubts arise as to to whether legislation awarding attorneys' fees and costs of litigation to taxpayers

is an appropriate solution. The ultimate decision, of course, is the prerogative of the Congress. In any event, if it is determined that the award of attorneys' fees and costs of litigation to taxpayers is an appropriate method of dealing with the situation, the legislation should be as simple as possible in order to minimize the potential for adding further litigation to an existing overly heavy caseload and should contain provisions authorizing the imposition of countervailing financial sanctions on taxpayers who pursue litigation which is either frivolous or groundless from its inception or attempt unduly to prolong their day of reckoning.

With these preliminary observations, let me turn to the several considerations which I have previously mentioned. They are interrelated in various degrees and my discussion of them will reflect this interrelationship.

B. Increasing caseload

I start with the unusually large volume of litigation pending before the Tax Court. In so doing, I recognize that this factor alone would not, in and of itself, justify not enacting otherwise meritorious legislation awarding attorneys' fees and costs to successful tax litigants. But, when the other elements of the picture are taken into account, the Court's caseload becomes a significant consideration.

Over the past decade the docket of the Tax Court has steadily increased. During the last three years the increase has been astronomical. Thus, at the end of the fiscal year 1970 there were 12,040 cases pending before the Court. By 1975, the number had increased to 16,448. Five years later, there were 34,865. As of July 31, 1981, there were 44,363, an increase of 275 percent over 1970.[1]

The Court is very concerned about this monumental increase in its docketed cases. We are making every effort to decide cases more promptly, and, in fact, the number of opinions and decisions has increased in recent years. In fiscal 1977, 1,088 cases were closed by opinion; by fiscal 1980, the number had increased to 1,397, and we estimate almost 2,100 in fiscal 1981. Yet it is becoming increasingly difficult, if not impossible, to dispose of a sufficient number of cases to close the gap between the number of cases filed and the number disposed of (see footnote 5, infra), much less to do so

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[1] The following table reflects the increase in pending cases on a yearly basis since the fiscal year 1970:

Fiscal Year	Pending Cases	Increase Over Prior Year
1970	12,040	886
1971	12,660	620
1972	13,388	728
1973	13,792	404
1974	13,727	(65)
1975	16,448	2,721
1976	18,396	1,948
1977	21,298	2,902
1978	23,140	1,842
1979	27,043	3,903
1980	34,865	7,822
1981 (through 7/31)	44,363	9,498
	45,000 → 46,000	

in a reasonable period of time. There is much truth to the saying that "justice delayed is justice denied." This has been recognized by the Congress, which has directed that "[a] report upon any proceeding instituted before the Tax Court and a decision thereon shall be made as quickly as practicable."[2]

We strongly believe that a law mandating the award of attorneys' fees and costs in tax litigation will significantly burden the Court by diverting judicial time and resources from the resolution of disputes involving substantive tax issues to those involving such fees and costs. The Commissioner of Internal Revenue, the respondent in all cases, may well oppose every, or nearly every, application for an award of attorneys' fees. Time will be consumed in hearing such disputes, in deciding whether fees should be awarded and, if so, in what amount, and in justifying such decisions in written reports as required by existing law.[3] Moreover, if the award of such fees and costs should cover settled cases (see pp. 8-10, infra), where historically the Court's involvement has been minimal, the diversion of judicial time and energy will be further accentuated. Thus, we think that, irrespective of whether an award of fees and costs is sought, all litigants before the Tax Court will be adversely affected.

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[2] Sec. 7459(a), I.R.C. 1954.

[3] Sec. 7459(b), I.R.C. 1954.

There would also be additional delay in those specific cases in which petitioners did seek awards of attorneys' fees and costs. The propriety and amount of such awards could only be judged after the Court rendered its decision. Hearings would in all likelihood be required. If such hearings were held in Washington, the parties (and their witnesses) would incur potentially significant additional expense. If such hearings were held in the city where the trial was conducted, the parties would have to wait for their case to be set on a calendar for that particular city. Thus, the time for disposition from the filing of a petition to the entry of decision would be significantly increased.

C. Settlement process

Another very important element for consideration is the impact of the potential award of attorneys' fees and costs on the settlement of cases pending before the Court. Our concern is that proposed legislation will discourage settlement. At this point, I think the Subcommittee will be interested to know that, based upon my conversations with several Federal circuit and district court Judges, their experience in other areas where legal fees are now legislatively authorized or mandated, e.g., civil rights, clearly indicates that the settlement process has been seriously impaired.

Historically, the capacity of the Tax Court to cope with the volume of cases brought before it has depended upon a very

high percentage of cases being resolved in this fashion.[4] The Court seriously doubts whether it could effectively handle its docket if the settlement rate declined, especially in view of the burgeoning number of new cases. In fact, we are already deeply concerned as to our ability adequately to cope with the growing gap between the number of cases filed and those being disposed of by both court disposition and settlement.[5]

Tax litigation certainly can be an expensive process -- both for the taxpayer and for the Internal Revenue Service, whose procedures are subject to fiscal and other constraints and are therefore not, as some people believe, unlimited. However, the cost of litigation does have a salutary effect. It encourages the parties seriously to consider and discuss the

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[4] The following table reflects the number and percentage of cases (including small tax cases) which were settled since the fiscal year 1977:

Fiscal Year	Total Cases Closed	Cases Settled	Percentage of Closed Cases Settled
1977	10,374	7,492	72
1978	12,062	8,801	73
1979	13,382	9,557	71
1980	14,470	10,723	74
1981 (through 7/31)	15,672	11,429	73

[5] The following table reveals this growing gap:

Fiscal year	Number of Petitions Filed	Number of Cases Disposed of by Settlement or Decision
1977	12,339	10,374
1978	13,740	12,026
1979	17,126	13,382
1980	22,009	14,470
1981 (through 7/31)	24,978	15,672

possibility of settlement. It is only logical that, with less economic pressure, taxpayers will be less inclined towards settlement. Similarly, it may be expected that the Service will be less inclined to settle issues favorable to the taxpayer for fear of appearing to have initially taken an "unreasonable" position. In either case, litigation will be encouraged.

D. Small tax cases

The potentially adverse impact of legislation providing for attorneys' fees and costs in small tax cases also cannot be lightly dismissed. The small tax case procedure was established in section 7463, I.R.C. 1954, by the Tax Reform Act of 1969 as a manifestation of the desire of Congress to provide a forum whereby taxpayers could have their cases disposed of informally, expeditiously, and without the necessity of legal representation. The only condition attached to the utilization of this procedure, which was optional with the taxpayer, was his loss of the right of appeal. The procedure has been eminently successful. Thanks to the diligence and tact of our special trial judges, some 35 percent of the cases filed with the Court are treated as small tax cases, with another 20 percent eligible for such treatment (something the Court would like to encourage). It is not hard to imagine that, with the potential for awards to taxpayers of attorneys' fees and costs, the likelihood of taxpayers electing the

small claims procedure will be substantially reduced. As a consequence, the caseload of the Court will become more difficult to handle, to say nothing of the fact that additional cases will be required to be heard by the courts of appeals, since by hypothesis the right of appeal will not have been waived.

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All in all, we view the prospect of legislation providing for attorneys' fees and costs with deep concern but, if the Congress decides to legislate in this area, I assure you that we will fully and willingly discharge any responsibilities which are placed upon us. However, we do have some suggestions as to the content of any such legislation, and it is to that aspect of the situation that I will now turn my attention.

II. Specific Suggestions for Legislation

A. Basic elements

Despite the existence of legislation authorizing attorneys' fees and costs in other areas, there has been practically no experience in the area of tax litigation. We think that, under all the circumstances and considering some of the difficulties already adverted to and subsequently discussed, three basic elements should be embodied in any legislation:

(1) The award of attorneys' fees and costs should not be mandatory but should be left to the discretion of the Court, as is now provided in the Equal Access to Justice Act.

(2) The period during which the legislation is to be operative should be limited. In short, there should be a sunset provision (such as is contained in the Equal Access to Justice Act).

(3) Because of the large number of cases pending before the Court, the legislation should be applicable only to cases begun (petitions filed) six months or more after its effective date. This will avoid the filing of amended pleadings in the large number of pending cases (see footnote 1, supra), with the huge administrative burden that would entail.

The foregoing basic provisions would afford the opportunity to determine whether the concerns which I have previously voiced have substance and to develop the experience necessary to evolve appropriate standards for determining when and how much fees and costs should be avoided.

B. Financial sanctions on certain taxpayers

As a concommitant of any legislation, we strongly urge the inclusion of countervailing provisions authorizing the imposition of fees, costs, and penalties in respect of certain unsuccessful taxpayers.

To balance the interests of the parties and provide a two-way street, we suggest that consideration should be given

to the propriety of authorizing an award of attorneys' fees and costs of litigation to the Government in appropriate cases in which it prevails. The prospect of such an award would have at least two salutary effects. It would encourage settlement, so essential to the ability of the Court to handle its caseload. It would also discourage taxpayers from filing frivolous and groundless petitions. The Tax Court is receiving an ever-increasing number of cases involving so-called tax protestors and others who do not raise bona fide, substantive tax issues for resolution but rather merely seek a forum in which to espouse their particular beliefs. Although the Court presently has summary procedures by which to deal with these cases, they nevertheless require a disproportionate amount of time and serve to divert the Court's attention from more deserving cases.[6]

Alternatively, or perhaps additionally, we suggest that consideration be given to amending section 6673, I.R.C. 1954. That section authorizes the Court to award damages to the United States in an amount not in excess of $500 in those instances in which the taxpayer has instituted proceedings

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[6] The Commissioner of Internal Revenue recently told the American Bar Association Section of Taxation that the government is losing billions of dollars each year in an uphill battle against tax evaders, illegal tax protesters, abusive tax shelters, and deadbeats. See Report of the Comptroller General dated July 8, 1981, on the subject Illegal Tax Protesters Threaten Tax System, submitted to the Chairman, Subcommittee on Commerce, Consumer and Monetary Affairs, House Committee on Government Operations.

merely for delay.[7] Again, in an effort to discourage the increasing number of unjustifiable petitions, the Court thinks that the maximum amount of damages should be substantially increased and the ground for awarding damages should be broadened to include frivolous and groundless cases. To date the effectiveness of the present section has been lessened by the difficulty in establishing that a specific taxpayer instituted proceedings "merely for delay."

C. Specific suggestions of statutory standards for awards are provided

First, we suggest that it would be more appropriate, as a standard, to use the standard of "arbitrary and capricious" rather than of "unreasonableness." This would be in keeping with what we understand to be the objective of legislation providing for the payment of attorneys' fees and costs in tax litigation, namely, to confine awards to situations where the

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7 The section reads as follows:

SEC. 6673. DAMAGES ASSESSABLE FOR INSTITUTING PROCEEDINGS BEFORE THE TAX COURT MERELY FOR DELAY.

Whenever it appears to the Tax Court that proceedings before it have been instituted by the taxpayers merely for delay, damages in an amount not in excess of $500 shall be awarded to the United States by the Tax Court in its decision. Damages so awarded shall be assessed at the same time as the deficiency and shall be paid upon notice and demand from the Secretary and shall be collected as a part of the tax.

Internal Revenue Service has abused the exercise of its power. Moreover, this is the standard which the courts have historically used when they have shifted to respondent the burden of proof which normally is on the taxpayer.[8] It is hard to see why a taxpayer should be entitled to fees and costs in a situation which a court would find not sufficiently egregious to shift the burden of proof from the taxpayer to the Government.

Second, whatever standard is used, it should be made clear, at least in the committee reports, that the determination should be made based upon all facts and circumstances revealed by the record in the case. It should depend upon the evidence finally presented.[9] We believe it important that the committee reports specify that the Court is not required to examine the record of the administrative hearings or base its decisions on the information available to respondent at the time the deficiency notice was issued. In this connection, we have considered whether there should be a requirement that the taxpayer has pursued all administrative remedies in order to be eligible for an award of attorneys' fees and costs of litigation. The absence of such a requirement would be likely to encourage taxpayers to bypass the administrative process and thereby increase the amount of litigation. However, the same consequences

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8 See Helvering v. Taylor, 293 U.S. 507 (1935).

9 This is the procedure envisaged by the Congress in determining whether a jeopardy assessment should be set aside or reduced under section 7429, I.R.C. 1954. See H. Rept. 94-658, 94th Cong., 1st Sess., 303 (1975); S. Rept. 94-938, 94th Cong., 2d Sess., 365 (1976).

would flow, although in a different context, if such a requirement were imposed. We would urge that any provision dealing with this problem be very carefully tailored so as to minimize any added burden of litigation. In any event, we think that the committee reports should make clear that, in situations where the taxpayer has withheld from the Service significant information until the actual trial, he should not be entitled to an award of fees and costs even if he wins the case.

Third, we think that attorneys' fees and costs should be limited to those incurred during the actual preparation of the case for trial, the trial itself, and possibly an appeal. In this context, the Congress will need to consider the desirability of specifying the factors or types of factors which ought to be taken into account. This is a difficult area. Factors considered by courts in the context of civil rights and other non-tax litigation[10] may not be completely

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10 A "classic" list of factors appears in Johnson v. Georgia Highway Express, Inc., 488 F.2d 174 (5th Cir. 1974), a civil rights case. There the Court of Appeals articulated the following twelve guidelines: (1) the time and labor required; (2) the novelty and difficulty of the questions; (3) the skill requisite to perform the legal service properly; (4) the preclusion of other employment by the attorney due to acceptance of the case; (5) the customary fee; (6) whether the fee is fixed or contingent; (7) time limitations imposed by the client or the circumstances; (8) the amount involved and the results obtained; (9) the experience, reputation, and ability of the attorney; (10) the undesirability of the case; (11) the nature and length of the professional relationship with the client; and (12) awards in similar cases.

appropriate when it comes to evaluating a fee application in the Tax Court. One factor that we think should be expressly recognized is whether the prevailing party's conduct unduly protracted the controversy.[11]

Another factor that needs to be thoroughly considered is the impact of the amount in controversy. The majority of cases docketed before the Court during the first ten months of the fiscal year 1981 involve deficiencies in dispute in amounts less than $5,000.[12] If the amount in controversy is to be considered, then an award of fees might not be sufficient to compensate counsel. On the other hand, if the amount in controversy is not to be a limiting factor, then awards in

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11 Cf. 28 U.S.C. sec. 1927 regarding counsel's liability for excessive costs.

12 The following table categorizes by amount in dispute the number and percentage of deficiency cases docketed from October 1980 through July 1981:

Category	Cases	Percentage	Cumulative Percentage
$ -0- - $ 1,000	4,947	22.5	22.5
$ 1,001 - $ 1,500	1,820	8.3	30.8
$ 1,501 - $ 2,500	2,320	10.6	41.4
$ 2,501 - $ 5,000	2,523	11.5	52.9
$ 5,001 - $ 7,500	1,283	5.8	58.7
$ 7,501 - $ 10,000	907	4.1	62.8
$ 10,001 - $ 20,000	2,498	11.4	74.2
$ 20,001 - $ 50,000	2,887	13.2	87.4
$ 50,001 - $ 100,000	1,293	5.9	93.3
$100,001 - $ 500,000	1,174	5.3	98.6
$500,001 - $1,000,000	158	.7	99.3
over $1,000,000	143	.7	100.0
no amount specified	2,992		
	24,945		

excess of that amount would be possible, and probably the rule in smaller cases. In considering this matter, the Congress should take into account the Court's special procedures applicable to "small tax cases" which are designed to permit taxpayers effectively to present their own cases without legal assistance. See pp. 10-11, supra.

The Congress will also need to consider whether, and by what measure, fees should be awarded to pro se taxpayers and taxpayers who are represented by "in-house" salaried counsel.

In a related vein, consideration should be given to the range of items that the Subcomittee considers to be "court costs." Existing law treats "costs" somewhat narrowly.[13]

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[13] 28 U.S.C. sec. 1920 provides as follows:

Sec. 1920. Taxation of costs.

A judge or clerk of any court of the United States may tax as costs the following:

(1) Fees of the clerk and marshal;

(2) Fees of the court reporter for all or any part of the stenographic transcript necessarily obtained for use in the case;

(3) Fees and disbursements for printing and witnesses;

(4) Fees for exemplification and copies of papers necessarily obtained for use in the case;

(5) Docket fees under section 1923 of this title;

(6) Compensation of court appointed experts, compensation of interpreters, and salaries, fees, expenses, and costs of special interpretation services under section 1828 of this title.

A bill of costs shall be filed in the case and, upon allowance, included in the judgment or decree.

"Costs" could arguably include expenses incurred for expert witnesses, accounting services, engineering reports, and any other item material to the litigation.

Finally, on the subject of the award, it may be that a maximum limit should be specified, for example, a fixed sum but, in any event, not in excess of twice the amount of the deficiency.

Fifth, it will be necessary to evaluate whether any award or denial of attorneys' fees and costs should be reviewable by the appropriate court of appeals and, if so, what standard should apply. It may well be appropriate to specify that any award or denial not be reviewable on appeal, as the Congress has done with respect of review of jeopardy assessments by the district courts.[14] In this connection, we note that, in small tax cases, the decision as to the amount of tax owed is not appealable (section 7463(b), I.R.C. 1954) and presumably this would apply to any award of fees and costs if such an award is to be made in respect of such cases. If appellate review is to be provided to any extent, we would suggest that the standard for review be that of a clear abuse of discretion.

I have left to the last what may prove to be the most troublesome issue which the Congress has to face, and that is how to determine initial eligibility for an award of

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[14] Sec. 7429(f), I.R.C. 1954.

attorneys' fees and costs. As I have previously pointed out, cases before the Tax Court often involve multiple issues. The taxpayer may win some issues and lose others. Indeed, most of the cases, whether disposed of by decision or settlement, fall into this category. If eligibility is defined in terms of the "prevailing party," how is that definition to be applied in such cases? Even confining the definition to the "significant issue" will not necessarily solve the problem. A $5,000 issue which the taxpayer wins may not be as significant as a $500 issue which he loses because the latter issue may dispose of a recurring problem in later years and, in that context, will clearly be the "significant issue." The possible permutations and combinations are endless.

III. Conclusion

The Tax Court handles over 90 percent of all tax cases brought before it, the district courts, and the Court of Claims. We are deeply concerned that legislation awarding attorneys' fees and costs of litigation in cases before the Court not unduly add to, and complicate, the already burdensome position in which the Court now finds itself and which is likely to prevail in the foreseeable future.

We think the following statement from the New York State Bar Association (see Hearings before the Senate Subcommittee on Oversight of the Internal Revenue Service of the Senate

Committee on Finance, on S. 1444, Taxpayer Protection and Reimbursement Act, July 19, 1979) is worthy of the Congress' most careful attention:

> . . . [I]t must be recognized that in legal disputes right and wrong are often matters of degree, or of fact; that a system that encourages the settlement of cases may be as desirable as one that pushes cases to trial; that the allowance of attorneys' fees may induce either more litigation or more prolonged litigation; and that any increased expenses of the Government will ultimately be borne by all taxpayers.

If Congress concludes that legislation is nevertheless deemed desirable, we again urge that it not make the award of fees and costs mandatory, but authorize such awards to be made in the discretion of the Court, that such standards as may be provided in the legislation be accompanied by appropriate specific guidance in the Committee reports, and that the legislation be applied only prospectively and be operative only for a limited period of time, so as to give the Congress an opportunity to reexamine the situation in light of experience.

In view of the scope of my comments, I believe it is unnecessary for me to evaluate separately each of the three bills presently under consideration.

Senator GRASSLEY. I would like to welcome back to this committee room, where they have been so many times already, people who, I have found, are very cooperative, Assistant Secretary for Tax Policy, John Chapoton, and the Commissioner of Internal Revenue, Roscoe Egger.

Who will start?

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Secretary CHAPOTON. I will start, Mr. Chairman. We have a joint statement that we would like to present for the record—it is rather lengthy. We each have a summary statement that we would like to present at this time, with the Chairman's permission.

Senator GRASSLEY. WITHOUT OBJECTION.

[The prepared statements follow:]

JOINT STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY, AND HON. ROSCOE L. EGGER, JR., COMMISSIONER OF INTERNAL REVENUE

Mr. Chairman and members of the subcommittee, We are pleased to present today the views of the Department of the Treasury and the Internal Revenue Service on legislative proposals for payment of attorneys' fees in tax litigation.

In general, we oppose extension of provisions authorizing broad-based attorneys' fees awards to the United States Tax Court. We would not oppose, however, a limited measure authorizing a discretionary award of fees in tax cases generally when the petitioner demonstrates that the Government has acted in bad faith. A provision such as this would allow for compensation in those cases in which the Government is guilty of overreaching, without encouraging a flood of new Tax Court litigation. By the same token, we would also recommend that provisions of section 6673 of the Internal Revenue Code, which already authorizes the Tax Court to impose an award of damages of up to $500 when a proceeding has been instituted merely for delay, be broadened to include bad faith conduct by private parties, and that the maximum amount of damages which may be assessed by the Court be increased significantly.

BACKGROUND

Attachment 1 contains some of the data which provides a backdrop for our position on attorneys' fees. It makes clear that the volume of Tax Court litigation is expanding at phenomenal rates. The problem today is not one of judicial access but of timely resolution.

IMPACT OF BROAD-BASED ATTORNEYS' FEES MEASURES

Among various legislative approaches to the award of attorneys' fees in tax cases are S. 1673 and other bills being considered by the Congress. These bills would award fees either whenever the Government loses (H.R. 1095 and 2555) or whenever the other party "substantially prevails" and the Government's position was "unreasonable" (S. 1673 and H.R. 3262). Under either standard, it appears that a substantial number of fee awards is contemplated. We are genuinely concerned about the budgetary implications of requiring all taxpayers to shoulder the expenses of those taxpayers who choose to litigate.

We are, however primarily concerned about the potential effect of such legislation on the Tax Court. Last June, the Tax Court docket reached 40,000 pending cases. By the end of the year, we estimate that it will approach 50,000 cases—a doubling of the Court's caseload in just five years. Efforts are underway within the Internal Revenue Service and the Office of the Chief Counsel to expedite pending matters. The Tax Court has also increased substantially its output and continues to explore new ways to expedite the handling of cases. Nonetheless, new filings this year will exceed dispositions by almost 8,000 cases. In short, major efforts will be required simply to manage the Court's existing caseload. Any new policy which encourages Tax Court litigation can only exacerbate an already serious problem.

Justice delayed is indeed justice denied, and the adverse impact of the Tax Court's

present docket is being felt by the Service and by those individual taxpayers entitled to prompt resolution of their legitimate disputes. We must also be mindful of the fact that unpaid deficiencies in excess of 5 billion dollars are the subject of Tax Court litigation, and that many additional billions of tax dollars are the subject of pre-litigation controversies. Further delays in resolving these matters will only increase burdens on the entire taxpaying public.

In our judgment, each of the attorneys' fees proposals being considered would significantly encourage more taxpayers to take their cases to Tax Court at a time when the Court is already experiencing difficulty in disposing of those cases now pending before it.

None of these proposals under consideration incorporates a requirement that the taxpayer exhaust the administrative appeals process prior to docketing a case in court. This could encourage taxpayers to bypass this level of administrative review and docket their cases directly in the Tax Court. By encouraging taxpayers to bypass the administrative appeals procedure of the Service, these measures undermine one of the principal forums for the orderly resolution of disputes and for reducing the Tax Court's flow of new cases. Consequently, we view the failure of these proposals to require that the taxpayer exhaust all administrative appeals before litigating as a serious defect.

The Tax Court has traditionally relied on the stipulation process rather than formal discovery to save time and expenses. The proposed attorneys' fees measures would only create incentives to "churn" cases through use of more formal procedures. Moreover, while we believe such conduct would preclude recovery, parties may be tempted to try to cause the Service to take unreasonable positions through nondisclosure until the eleventh hour, creating a barrier to the free exchange of information which is the bedrock of the stipulation process. Accordingly, the proposals' failure to require good faith and timely disclosure by a taxpayer of the facts of the taxpayer's case represents another serious flaw.

The measures under consideration could also have an adverse impact on so-called "small case" procedures under Code Section 7463. These procedures were adopted by Congress to provide for an informal and expeditious method of resolving cases involving relatively limited amounts in controversy (since 1979, $5,000 or less). Not only has this approach served the interests of numerous taxpayers—but the use of special trial judges to hear these matters has freed up invaluable Tax Court time to deal with its expanding backlog of cases. The proposed attorneys' fees measures under consideration would create incentives not to use the small case procedure at all, or to introduce more costly and time-consuming formalities.

Finally, all else aside, the current backlog problem would only be compounded by additional demands on the Court's time for purposes of resolving attorneys' fees claims—not to mention increased IRS costs in processing such claims.

Perhaps the most serious defect in all the proposals, however, is the failure to address precisely what cases are appropriate for fee awards. As noted below, we would not oppose a provision giving relief in cases of "bad faith" conduct by the Government. We think such conduct occurs infrequently; when it does, compensation may well be appropriate. However, we are very troubled by suggestions that fee awards may be appropriate on a "strict liability" basis or when the Service seeks to establish the meaning of the tax law through litigation.

The function of the Internal Revenue Service is to administer the Internal Revenue Code, after tax policy is determined by Congress. The meaning of a given Code provision may be subject to varying interpretations. Revenue Service employees are charged with the responsibility of applying and administering the law in a fair, impartial, practical, yet vigorous, manner. We are very concerned that a vague standard such as "reasonableness", when adopted in a tax context, may have a chilling effect on the enforcement of the internal revenue laws.

ATTORNEYS' FEES IN CASES OF BAD FAITH GOVERNMENT ACTION

We believe that disadvantages associated with any provision for attorneys' fees in tax cases far outweigh any potential benefits. On the other hand, we cannot condone, and the system should not tolerate, bad faith Government conduct. While we have some reservations concerning its practical impact on the settlement process and the Tax Court backlog, we would not oppose a statute imposing liability for fees and costs in cases where the Government is shown to have acted in bad faith. This standard has the virtue of proscribing egregious conduct by the Government, is reasonably well-defined by existing case law, and minimizes settlement disincentives. If this proposal were adopted, we would urge that it be made clear that the

standard for recovery should be construed strictly by the Courts and that "clean hands" are a prerequisite to recovery. Thus, for example, taxpayers who withhold information until the eleventh hour, fail to avail themselves of administrative remedies, delay proceedings, and the like should not be entitled to fees and costs. We also believe that the measure should not apply to pending cases, should include a "sunset" provision, and should exclude certain types of ancillary proceedings.

MODIFIED TAXPAYER PENALTY PROVISIONS

In our view, the isolated instances of bad faith Government conduct in tax cases pale before systematic abuses by certain taxpayers and taxpayer groups. Attachment 1 sets forth the number of abusive tax shelters and tax protester cases. These numbers do not begin to count the toll in terms of IRS and judicial resources. Nor do they reflect other instances where taxpayers benefit from the use of Government funds through overt and covert delay.

Virtually all tax shelter litigation takes place in the Tax Court. The ease with which Tax Court cases can be filed, the fact that the amount of the disputed tax is not due until the litigation is completed, and the delay in bringing cases up for trial, have led some investors in tax shelter schemes to realize that Tax Court litigation is itself a form of shelter. As the increasing number of tax shelters and other cases move through the administrative pipeline, we expect the Court's total number of cases to continue to increase dramatically.

If we cannot condone bad faith Government conduct, then in equal measure we cannot condone similar conduct when engaged in by taxpayers. Code Section 6673 presently authorizes the Tax Court to award damages of up to $500 against taxpayers who institute Court proceedings merely for delay. This provision has been construed very narrowly by the Court and does not reach conduct amounting to bad faith by the taxpayer. We urge that Section 6673 be amended to allow the Tax Court, at its discretion, to award damages in those situations in which the taxpayer is found to have acted in bad faith. We also urge that the maximum amount of an award under this provision be increased significantly.

COMMENTS ON S. 1673

As indicated, we believe that any broad-based attorneys' fees measure would be ill-advised and counter-productive in the context of tax litigation. However, we recognize that efforts have been made to minimize a number of the problems we have described—most notably in S. 1673 [1]. If a broad-based attorneys' fees measure is to be enacted, we feel that moderating features similar to those included in S. 1673 are necessary. For example, such legislation:

Should require that the taxpayer prove the Government's position unreasonable and substantially prevail as to amount or most significant issue(s) in controversy.

Should exclude from its coverage cases involving creditors of the taxpayer, declaratory judgments, summons proceedings, and State Court cases.

Should incorporate a reasonable monetary limit on the amount of award.

Should permit multiple actions which could have been joined as a single proceeding to be treated as a single action for fee award purposes.

Should exclude pending cases and incorporate a "sunset" provision.

However, we would supplement these provisions with the following:

A requirement that the taxpayer exhaust administrative remedies.

Denial of recovery if the taxpayer fails to make timely and good faith disclosure of the taxpayer's case.

Clarify that attempts by the Service to modify administrative positions which it determines to have been in error, and to litigate in instances where adverse decisions exist, are not per se unreasonable and are not per se grounds for recovery.

Having said as much, however, we remain convinced that any such measure, regardless of how finely drafted, will confer only marginal benefit from the standpoint of facilitating private party access to the judicial process—and could well have a material adverse impact on settlement procedures, the timely judicial resolution of tax cases, and the vigorous and even-handed enforcement of the tax laws by the Service and by a Tax Court already under severe stress from its docket.

COMMENTS ON THE EQUAL ACCESS TO JUSTICE ACT

In excluding Tax Court cases from its coverage, the Equal Access to Justice Act properly recognizes their unique nature and the fact that different treatment for fees and costs might well be appropriate. We believe that the Act's objective of

[1] H.R. 1095 and 2555 appear to impose a standard of strict liability. As such, they would exacerbate problems associated with any broad-based attorneys' fees measure.

facilitating access to the courts can best be met by encouraging administrative settlement of tax cases and that extending attorneys' fees coverage to the Tax Court would be counterproductive.

Ideally, we would prefer that the Equal Access to Justice Act's coverage of tax cases in the District Court and the Court of Claims be eliminated. The adverse impact on Service and judicial resources in handling attorney's fees claims and the risk of encouraging litigation rather than administrative settlement of cases are even greater under the Equal Access to Justice Act than under S. 1673. However, because the Equal Access to Justice Act is in place and is to some extent experimental, and because the vast preponderance of tax litigation is before the Tax Court, we do not feel compelled to advocate modification of the Equal Access to Justice Act at this time. On the other hand, if a "bad faith" standard is enacted for the Tax Court, we would urge that it be adopted as the exclusive basis for an award of attorneys' fees in tax litigation not only in the Tax Court but in the District Courts and the Court of Claims as well.

CONCLUSION

The decision whether to provide for attorneys' fees in tax litigation requires balancing a number of competing considerations: Access to the judicial process and restraint of unwarranted Government action; timely judicial resolution of pending controversies; and proper enforcement of the tax laws. In our view, a broad-based attorneys' fees statute—regardless of how carefully drafted—would contribute only marginally to the objectives of access and restraint, while detracting materially from the objectives of timely dispute resolution and proper law enforcement.

We appreciate the opportunity to appear before you this morning and would be happy to respond to any questions you may have at this time.

ATTACHMENT 1

Tax Court Docket (Excluding "S Cases")

Year	Cases Initiated	Cases Disposed of	Year-End Inventory
1967 (July to June)	6,857	7,482	10,376
1972 (July to June)	5,980	6,262	11,068
1977	8,576	6,921	18,335
1978	10,332	8,926	19,664
1979	11,800	8,596	22,868
1980	12,711	8,506	27,703
1981*	19,600	9,600	37,703

— Approximately 2,000 cases involve so-called tax protesters (6.3% of the Tax Court's inventory).**

— Approximately 8,000 cases consist of what the Service considers abusive tax shelter cases (24.29% of the Tax Court's inventory).

— The Service estimates that during 1981, more than 35,000 cases will be settled in their entirety during administrative appeals prior to commencement of litigation.***

— In June 1979, the jurisdictional limit for so-called "S Cases" was increased from $1,500 to $5,000.

— In the vast majority of Tax Court cases, a significant number of additional issues had been raised on audit but were settled prior to commencement of litigation.

— The number of "S Cases" filed in 1976 was 3,692; in 1980, 7,949 were filed.

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* Projected

**Excluding so-called Small (or "S") Cases under Code Section

*** Excludes cases resolved in their entirety during the audit phase.

Secretary CHAPOTON. Commissioner Egger and I are pleased to appear before the subcommittee today to present the Department of the Treasury and the IRS views on several legislative proposals for payment of attorney's fees in tax litigation.

In general, we oppose any extension of provisions authorizing broad-based attorney's fees awards to the U.S. Tax Court.

We believe the disadvantages associated with any provision for attorney's fees in tax cases far outweigh any potential benefits. On the other hand, we cannot condone, and the system should not tolerate, bad faith Government conduct. While we have some reservations concerning the practical impact on the settlement process and the Tax Court backlog, we would not oppose a statute imposing liability for fees and costs in cases where the Government is shown to have acted in bad faith.

If such a proposal were adopted, we would urge that it be made clear that the standard for recovery should be construed strictly by the courts and that "clean hands" are a prerequisite to recovery. We also believe that the measure should not apply to pending cases, should include a sunset provision, and should exclude certain types of ancillary proceedings such as those involving creditors of the taxpayer, declaratory judgments and summons proceedings.

We also recommend that the existing provision of the Internal Revenue Code, which authorizes the Tax Court to impose an award of damages of up to $500 when a proceeding has been instituted merely for delay, be broadened to include bad faith conduct by private parties, and that the maximum amount of damages which may be assessed by the Court be increased significantly beyond that $500 figure presently authorized.

Although we believe that any broad-based attorney's fees measure would be ill-advised and counterproductive in the context of tax litigation, if such a measure is to be enacted, we feel that the moderating features similar to those included in S. 1673 are necessary.

However, we remain convinced that any such measure will confer only marginal benefit from the standpoint of facilitating private party access to the judicial process, and could well have a material adverse impact on settlement procedures, on the timely judicial resolution of tax cases, and on the vigorous and even-handed enforcement of the tax laws by the Service and by a Tax Court already under severe stress from its very large docket.

I'd like to turn to Commissioner Egger to discuss the administrative implications of the various legislative approaches being considered, Mr. Chairman.

Senator GRASSLEY. Mr. Commissioner.

STATEMENT OF HON. ROSCOE L. EGGER, JR., COMMISSIONER OF THE INTERNAL REVENUE SERVICE

Commissioner EGGER. Mr. Chairman, Senator Baucus, among various legislative approaches to the award of attorney's fees in tax cases are bills currently under consideration by the Congress that would award fees either whenever the Government loses or whenever the other party "substantially prevails" and the Government's position was "unreasonable." Under either standard, it appears that a substantial number of fee awards is contemplated. We are

genuinely concerned about the budgetary implications of requring all taxpayers to shoulder the expenses of those taxpayers who choose to litigate their cases.

We are, however, primarily concerned about the potential effect of such legislation on the Tax Court. We have included with our written statement, data on the Tax Court docket. This data makes clear that the volume of Tax Court litigation is expanding at phenomenal rates. The problem today is not one of judicial access but of timely resolution.

Last June, the Tax Court docket reached 40,000 pending cases. We estimate that by the end of the year, the Tax Court docket will approach 50,000 cases, a doubling of the Court's caseload in just 5 years. The adverse impact of the Tax Court's present docket is being felt by the Service and by those individual taxpayers entitled to prompt resolution of their legitimate disputes.

We must also be mindful of the fact that unpaid deficiencies in excess of $5 billion are the subject of Tax Court litigation, and that many additional billions of tax dollars are the subject of prelitigation controversies. Further delays in resolving these matters will only increase burdens on the entire taxpaying public.

In our judgment, each of the attorney's fees proposals being considered would significantly encourage more taxpayers to take their cases to the Tax Court at a time when the Court is already experiencing difficulty in disposing of these cases now pending before it. Also, the current backlog problem would only be compounded by additional demands on the Court's time for purposes of resolving attorney's fees claims.

None of the proposals under consideration incorporates a requirement that the taxpayer exhaust the administrative appeals process prior to docketing a case in court. By encouraging taxpayers to bypass the administrative appeals procedure of the Service, these measures undermine one of the principal forums for the orderly resolution of disputes and for reducing the Tax Court's flow of new cases.

The proposals' failure to require good faith and timely disclosure by a taxpayer of the facts of the taxpayer's case represents another serious flaw.

The measures under consideration could also have an adverse impact on so-called "small case" procedures. These procedures were adopted by Congress to provide for an informal and expeditious method of resolving cases involving relatively limited amounts in controversy. The proposed attorney's fees measures under consideration would create incentives not to use the small case procedure at all, but to introduce more costly and time-consuming formalities.

Perhaps the most serious defect in all the proposals is, however, the failure to address precisely what cases are appropriate for fee awards. We are troubled by suggestions that fee awards may be appropriate on a "strict liability" basis or when the Service seeks to establish the meaning of the tax law through litigation. We are also very concerned that a vague standard such as "reasonableness," when adopted in a tax context, may have a chilling effect on the enforcement of the Internal Revenue laws.

In excluding Tax Court cases from its coverage, the Equal Access to Justice Act properly recognizes their unique nature and the fact

that different treatment for fees and costs might well be appropriate.

Ideally, we would prefer that the Equal Access to Justice Act's coverage of tax cases in the district court and the Court of Claims be eliminated. However, because the Equal Access to Justice Act is in place and is to some extent experimental, and because the vast preponderance of tax litigation is before the Tax Court, we do not feel compelled to advocate modification of the Equal Access to Justice Act at this time.

On the other hand, if a "bad faith" standard is enacted for the Tax Court, we would urge that it be adopted as the exclusive basis for an award of attorney's fees in tax litigation not only in the Tax Court but in the district courts and the Court of Claims as well.

Mr. Chairman, we appreciate the opportunity to appear before you today. And would be most happy to respond to any questions you have at this time.

Thank you.

Senator GRASSLEY. I have some questions. And I am sure Senator Baucus will as well.

First of all, Mr. Egger, my first question is kind of a philosophical one. And I guess, in a sense, I am asking you to back off from your, in a sense, company position which is frequently to save as much revenue as possible, and answer this question as an administrator.

Isn't it foreseeable that the IRS will be more careful if threatened with paying a taxpayer's attorney's fees?

Commissioner EGGER. I'm not sure I would characterize it as being more careful. Possibly. Possibly that would be true in some cases. But I think that in as many, if nor more, situtations, the individual examiners might be inclined to back away from positions that they ought properly to hold simply because they don't want to be held responsible for having brought a case up that ultimately winds up in the award of attorney's fees.

So much depends on the standards that are set. Where the IRS, in fact, brings an adjustment which results in litigation that does represent bad faith on the part of the Internal Revenue Service, we certainly agree that the taxpayer is entitled to some kind of protection under those conditions. However, we also are firmly convinced that that should go both ways.

I can assure you, Mr. Chairman, that we are in court more often on grievous situations that are brought by the taxpayer rather than the other way around.

Senator GRASSLEY. Wouldn't the award of attorney's fees make it easier to spot personnel who are acting in an irresponsible manner? Or maybe better put, wouldn't it serve as a deterrent to individual agents who maybe are adventuresome beyond the intent of the law?

Commissioner EGGER. Yes, Mr. Chairman, I would agree with that. As I pointed out earlier, that comes close to fitting a standard that I would refer to as a bad faith standard. And if any of our agents or any of our representatives are taking positions that are clearly not called for under the statute, for harassment purposes or otherwise, I quite agree that the taxpayer is entitled to protection there.

Senator GRASSLEY. Of course, the bad faith standard then would make it even easier—it might encourage that sort of irresponsible manner more than the unreasonable standard.

Commissioner EGGER. I'm afraid I don't understand that. If it is a question, I guess I don't agree.

Senator GRASSLEY. All right. You don't agree. One of the concerns you raised, and I want to ask both you and Mr. Chapoton—one of the concerns you raised in your testimony that my amendments address is that taxpayers might not exhaust their administrative remedies within IRS before proceeding to the courts. Is there a procedure whereby the IRS and the taxpayers can go straight to court if the issue is one which the agency could not decide?

Commissioner EGGER. Yes, indeed. The taxpayer can ask for and we can proceed to immediately issue a statutory notice of deficiency which permits him to go directly to the Tax Court. This is done in a great many cases.

Senator GRASSLEY. All right. Go ahead.

Secretary CHAPOTON. I would like to point out, Mr. Chairman, that your amendment, as recommended in our testimony, would be an essential addition to any lesgislation in this area because the administrative process and the settlements that result in the administrative process are crucial to our tax system. These procedures are crucial to preventing even a further overloading of the Tax Court.

Senator GRASSLEY. Then you are satisfied that if there is evidence that the appeals process is useless or a waste of time that it can be taken to the courts?

Secretary CHAPOTON. Yes, I think that is correct. And many times, the positions are so firm and so directly and diametrically opposed that litigation is the only solution.

Senator GRASSLEY. If we place a limit on this bill restricting the recovery of attorney's fees to taxpayers who have made a good faith effort to resolve the dispute by administrative remedies within the IRS, would this satisfy your concern regarding the impact of this legislation on IRS administrative remedies?

Commissioner EGGER. Basically, yes, except that I have just some slight concern as to a good faith effort. It seems to me that the administrative remedy route is quite clearly spelled out. And, therefore, there is little question of whether the taxpayer has or has not followed his administrative remedies.

I would be concerned that if we introduced yet another standard in there, a judgment, that we would get into all sorts of debates as to whether a taxpayer missed a deadline in good faith or he didn't miss it in good faith and that kind of thing. I would certainly want a little more specific——

Senator GRASSLEY. In the final analysis, though, the Tax Court is going to make that determination.

Commissioner EGGER. The Tax Court can make that determination.

Senator GRASSLEY. Mr. Egger, why do you favor a bad faith standard as opposed to an unreasonableness standard for awarding attorney's fees?

Commissioner EGGER. Mainly because the question of reasonableness in the tax cases are so difficult to apply whereas the bad faith standard is one in which the courts are already in the habit of applying in other situations. And it does carry some sort of an element of intent, meaning that this couldn't be just an honest difference of opinion between the taxpayer and the representatives of the Government.

Senator GRASSLEY. That gets back to the question, then, that I asked you that you didn't quite understand in regard to the IRS employees being responsible to the extent to which the unreasonableness standard is a little easier to prove. Would that not make it more of an incentive for them to be less responsible? Remember the question I asked you?

Commissioner EGGER. I do. I am just still trying to figure out for sure that—let me see if I can restate it.

Your suggestion is that if we have a reasonableness standard, since it would be somewhat more complicated and somewhat more difficult to apply, that this would make the Revenue employees a bit more careful?

Senator GRASSLEY. Let me state it a little better on my next question. This will be the best way to put it. Since the Tax Court judge is given discretion to determine if the position of the Government is unreasonable, is it your concern that the Tax Court judges will administer this standard in such a way that it will have a chilling effect on the enforcement of the Internal Revenue laws?

Commissioner EGGER. Yes, I'm concerned about two aspects of it. That's one. And the other one is that it will simply be an added complexity in the Tax Court proceedings, which will further slow down the process of disposition of cases. And since we are running about 8,000 or 9,000 cases a year slower in dispositions than they are coming in the front door in the Tax Court at this time, we must find ways to speed that up rather than slow it down.

Senator GRASSLEY. As a practical matter, though, isn't it true that any standard allowing taxpayers to recover attorney's fees may have a chilling effect on the enforcement of the Internal Revenue laws? Let me put it even more philosophically. Wouldn't it encourage abuse in enforcement, an issue that Senator Baucus and I are concerned about?

Commissioner EGGER. I have to agree that if there is hanging over the head of the representatives, whether the Revenue agent or where the responsibility happens to fall, of taking a case ultimately into the Tax Court, it could have that effect.

The problem with it is that it tends to over simplify the actual process. These cases, in the field, go through about three hands of different staff responsibilities before they ever get to the Tax Court stage. So the Revenue agent himself who raises the issue—that issue is ultimately then moved over into the appeals divisions where totally unrelated tax staff people have the responsibility to review that issue de novo. And then it goes from there, if it is docketed in the Tax Court, into the hands of the Office of Chief Counsel so that it is hard to see how the Revenue agent who raises the issue first would be very closely related to whether or nor this might be a case that would be deemed unreasonable enough to award attorney's fees.

Senator GRASSLEY. Well, then you——

Commissioner EGGER. I just sort of double that is really going to happen in very many cases.

Senator GRASSLEY. Now under current law, since the taxpayers can recover attorney's fees brought in Federal District Court or the U.S. Court of Claims, what impact do you think the current law will have on litigation of tax disputes if Congress does act to provide for an award of attorney's fees in cases before the Tax Court?

Commissioner EGGER. Quite frankly, we are a little apprehensive about whether or not it will have any major impact. About 93 percent of our litigation today is in the Tax Court anyway. And in order to bring into play the equal access statute, the taxpayer, in either the district court or the Court of Claims, has to first pay the deficiency. And then go on into court, taking his chance as to whether he will be awarded attorney's fees. And my own feeling is that although we will clearly have some issues under that act, we doubt seriously that it is going to have major impact.

One of the things we would like to do is just sort of hold where we are and see what happens, using that limited application of the rule as a kind of a "pilot test," if you will, of the need for this kind of provision.

Senator GRASSLEY. Let's suppose that I agree in suggesting the amendment—I haven't reached that conclusion yet—to exclude so-called "small cases" under Code Section 7463. But except for specific cases and instances such as this, why shouldn't this legislation only give the Tax Court judges some guidance and leave as much discretion as possible to the Tax Court judges to determine whether an award of attorney's fees is appropriate in the amount of that award?

Commissioner EGGER. We are leaving aside the "S" cases for this purpose?

Senator GRASSLEY. Yes.

Commissioner EGGER. I suppose the Tax Court would be as appropriate a body to decide the applicability of the award in a given situation. I see no objection there.

Senator GRASSLEY. Do you believe that increasing the Code Section 6673 damages from $500 to something larger, like, let me suggest, $5,000 which are assessable against the taxpayer for instituting proceedings merely for delay, will improve this bill?

Commissioner EGGER. That is the trade off for having awards cut both ways. In other words, instead of having the taxpayer reimburse the Government for attorney's fees, which would have to be simply a theortecial number, the suggestion was made that we simply increase by a significant amount the amount of damages, and then broaden the concept. That is, broaden the circumstances under which such damages could be awarded so that when taxpayers, as they frequently do, bring spurious cases into the Tax Court and take up the court's time, they would know in advance that they would have to most likely pay for that.

Senator BAUCUS. Mr. Commissioner, Mr. Secretary, as you probably know, the department, during the last time this bill went before this committee, testified in favor of the unreasonableness

standard. Let me just quote you part of that testimony. This is a Mr. Lubbic.

The use of an objective test as opposed to the question of bad faith in terms of subjectivity, we think is also appropriate. The courts are at issue with this question. We think they ought to be able to deal with this on the basis of objective factors.

I am just wondering why that department has changed its mind.

Secretary CHAPOTON. Senator, I am, of course, aware of the position that Mr. Lubick took. I do not know all the background that led to the conclusion. All I can state is that we reviewed this entire area in great detail when it came up for our consideration. We are very concerned, as is the Tax Court, about the large docket the Tax Court has developed over the past years. That condition was evident, I'll concede, when Mr. Lubick testified as well. It has grown even more serious in the past year. We come to this problem with that conceren in mind and we do not think a reasonableness standard will be as easy as Mr. Lubick seemed to think it might be to administer. Indeed, I think the written statement of the Tax Court submitted by Judge Tannenwald points out this problem. It will be difficult to determine what is "reasonable."

Senator BAUCUS. Caseloads also. What of——

Secretary CHAPOTON. Yes. It will, of course, also involve larger caseloads, because it will take up the time of the court to make such determinations.

We recognize the reason for considering such legislation. Indeed, it seems unfair when a taxpayer maintains a position, maintains he is right through audit and through the administrative appeal procedures; goes to the Tax Court and wins. That taxpayer has a case in which he has said that he was right all along, and the Internal Revenue Service was wrong all along. Why shouldn't I have the Government pay my cost, that taxpayer says. That is a very appealing situation.

But what we are really saying is that all taxpayers ought to pay for that taxpayer's right to litigate his case—a right he has in any event. The question of having all other taxpayers paying for the litigation is a much more difficult question.

Senator BAUCUS. As you see it, what does the taxpayer have to prove in order to prevail under a bad faith standard as opposed to an unreasonableness standard?

Secretary CHAPOTON. It would be a difficult thing. He would have to prove that the Internal Revenue Service was, in effect, overreaching. That is, there was no basis in pursuing the case against him.

Senator BAUCUS. So far, it sounds like unreasonableness.

Secretary CHAPOTON. Well, in fact, there would also have to be an ill will shown.

Senator BAUCUS. So if the taxpayer has to get it to the subjective intent——

Secretary CHAPOTON. I really think we are going to have subjective intent in either case.

Senator BAUCUS. But certainly, the taxpayer would have to get more into the subjective attempt for the bad faith standard over the reasonableness standard. In fact, I don't see how he is going to get the reasonableness standard anyway. We are talking about subjective reasonableness—reasonableness, whether it was reason-

ableness or unreasonableness, it is still an objective standard. That's how the Service interpreted the standard in the testimony that I quoted. So if it is an objective standard rather than a subjective standard, it is time to delve into the internal motives of the Service. And then you get into the question of which rules of the Service they are talking of.

It seems to me that the bad faith standard very much requires the taxpayer, who is going to be successful, to prove the bad faith. It has been my experience that—the taxpayer has to go outside his record probably. It is a harder standard to prove.

Secretary CHAPOTON. Senator, I agree. Very few taxpayers would prevail. A taxpayer would have to make a record on bad faith and it would not be easy to do. I agree completely.

Let me back away from this point for a minute. I guess, in one sense, the state of mind would not be as important if the test were based on whether the Government's position were unreasonable. It would simply be that the court would have to inquire, I suppose, in deciding whether the IRS was unreasonable in pursuing this position.

But this inquiry will only take place after the court has decided that the IRS was wrong. It would seem that this legislation is telling the court that, after you decide the IRS is wrong, you must then decide whether it was unreasonable in pursuing the positions which were wrong. This is a very difficult question to present to a court.

Senator BAUCUS. A bad faith step for the third step.

Secretary CHAPOTON. That's correct. We shouldn't make any bones about that. The bad faith test would limit severely the applicability of the attorney's fees award. We are also saying that this standard ought to go both ways. That is, the taxpayer ought to be liable for attorney's fees or costs or penalties of some sort when he acts in bad faith. In this case, the Government would have to build a similar record when——

Senator BAUCUS. The taxpayer——

Secretary CHAPOTON. This is a standard that is way short of criminality. In the case when the taxpayer does institute a proceeding principally for purposes of delay, for example, we think that such a penalty may be appropriate and we make this point in the testimony. Indeed, the fact that you can go to the Tax Court without paying your tax gives you an assurance of delay if you go that route. And in some cases we are talking about delays of a number of years. And we know that a number of taxpayers go to the Tax Court for that purpose.

Senator BAUCUS. I am concerned about the exhaustion of administrative remedies. Don't you think that some kind of standard of reasonableness makes sense here because there are so many different stages that the taxpayer may or may not go through? It is difficult to know precisely what is the final administrative remedy.

But a taxpayer may have sat down four or five or six times with personnel in the Service. Because of the complexity of the field procedure, it seems to me, again, that some kind of reasonableness standard makes more sense. I can understand that it might be more of a burden on a judge, but that is why they are judges. They are forced to make difficult decisions sometimes.

Secretary CHAPOTON. Commissioner Egger wants to comment on that. But let met just state——

Senator BAUCUS. The fact of the matter is if we are neat and precise, it wouldn't go to a judge anyway.

Secretary CHAPOTON. There has to be some such——

Senator BAUCUS. I——

Secretary CHAPOTON. I think you agree with the need to not undermine the administrative procedures.

Senator BAUCUS. That's correct.

Commissioner EGGER. I was about to get that point across too. In thinking through it a little bit, I might want to add to what I said earlier. Namely, that particularly in the case where these attorney's fees awards go both ways. That is, they go in the case of taxpayer awards and Government awards against taxpayers. Because we do have the situation where taxpayers, in part at least—groups that we refer to as "tax protesters," when they have come into the administrative procedure have adopted and followed a series of just unbelievably delaying tactics in the administrative process. And ultimately wind up in the Tax Court.

And it may well be that one would have to question whether or not they pursued their administrative remedies in a reasonable fashion. So there may be a good point to that; particularly, as I say, if these awards go both ways.

Senator BAUCUS. I agree. If the taxpayer is unreasonable in his use, there should be some remedy there too. Perhaps the remedy is a number of steps in the administrative process. That cuts both ways. That might help the Service to get quicker action.

But do either of you think that there should be some standard of reasonableness with respect to exhaustion of administrative remedies? Or should there be a fairly strict provision in the bill that requires a taxpayer to exhaust nearly every administrative remedy before he goes to the Tax Court?

Commissioner EGGER. I think perhaps that it was a requirement that the administrative remedies be exhausted in reasonable fashion, that that would solve the problem.

One of our concerns would be that too many taxpayers, in order to presumably thrust the cost burden on the Government, would not want to pay anybody to handle their case through the administrative process, but would prefer to go right into the Tax Court since the fees charged by their representatives wouldn't be reimbursable at the administrative level.

And that's the one concern that we have. No. 1, it just bypasses a very important part of the whole procedure. And the other one is that it would unnecessarily again burden the Tax Court far beyond what it is today.

I do feel, however, that if we said they had to pursue their administrative remedies in a reasonable fashion that that would preclude some of the things we are running into in the field such as the long list of questions that we get back have absolutely nothing to do with the tax case. And things of that sort.

Senator BAUCUS. Are there too many steps in the appeals process?

Commissioner EGGER. I don't think so. Those are under constant reexamination. We are literally constantly reviewing and reviewing the effect in order to——

Senator BAUCUS. I'm not an expert on the steps along the way. That an average small business taxpayer of average means—how many steps? Give me a ball park figure.

Commissioner EGGER. Well, we would hope that beyond the Revenue agent's report for a 30-day letter, which is the first stage after the examination, that most of the cases can be closed out in the appeals division, which is simply the second step. And to the extent that they cannot be, then the—that's the whole purpose of the Tax Court.

In any law that is as complex as the Internal Revenue Code, it stands to reason that there will be difficult, very complicated questions of interpretation, that the judicial process is important in resolving.

Senator BAUCUS. I'm surprised to hear you say only two. Some taxpayers have told me that there are a lot more than two in the process. I guess it is something I will have to look into later.

Commissioner EGGER. Not two steps—no. Two steps: Is it in the administrative process? It is entirely possible that they would have a series of meetings, let's say, both in appeals or even with the examining officers of the Internal Revenue Service. But the steps themselves are simply two steps, and then into the Tax Court or another court.

Senator BAUCUS. Thank you both.

Senator GRASSLEY. I have one more question. In your testimony on line 5, you referred to the fact that we are very troubled by suggestions that fee awards may be appropriate on a strict liability basis. This statement concurs in the case when the Service seeks to establish the meaning of tax law through litigation.

In that instance, you are trying to justify that the taxpayer can be put to considerable expense in helping the IRS to determine what the law is. Now isn't that really unjustified in the instance of where a person has to defend himself, or when the IRS is trying to determine what the law really says.

Secretary CHAPOTON. Mr. Chairman, what happens—and let me even suggest that in that particular instance, it would seem even more reasonable that the taxpayer would get an award for attorney's fees as opposed to ones where that unique determination of what the law means may not be as basic an issue. Particularly, where statutes are for the first time being interpreted by the courts.

Commissioner EGGER. The problem arises where we get one decision in one court in a particular jurisdiction, and an opposing decision in another court. Such as, for example, we might have a decision in the Tax Court going one way and a decision in the Court of Claims going the other way.

It is important, therefore, for us to pursue that out until we have finally decided—the courts have finally decided what the real interpretation of the statute is going to be. And this happens with a fair degree of frequency in very, very difficult, complicated issues.

Typically, we go into a court of appeals in one circuit and have it resolved there. And if the other case was in another circuit, we do

the same thing in the other circuit so that we can determine whether the issue is going to be resolved by the two courts at the circuit level. And I know of no other way to do it except to just arbitrarily accept the first court's decision that comes down the road, which I suspect wouldn't do us too much good in the whole aspect of tax administration.

Secretary CHAPOTON. Mr. Chairman, I would like to add to that. Just keep in mind that none of us would want the Internal Revenue Service to do anything except proceed with a litigating position consistent with the policy that has been established in the regulation.

It is true that some taxpayer is going to be on the other side of that litigation. In the case where that taxpayer wins, the claims would be that the IRS is unreasonable. The claim would also be to the contrary when the IRS prevails, I suppose. It is simply not a case where the Government can decide that it ought to pay for the costs of the other party when the IRS is pursuing what it perceives as the legitimate policy of Congress in enacting a statutory provision.

Commissioner EGGER. Frequently, a lot of taxpayers get kind of a free ride. They file their petition, and then the case gets suspended while it is resolved in another jurisdiction. And if we lose, literally, their case has been resolved at the same time in their favor. So it cuts both ways. It's not the kind of thing that we want or is desirable, but it is forced upon us and it is a means of trying to determine, ultimately, how to apply some of these complicated provisions.

Senator GRASSLEY. Thank you both very much for your—wait a minute.

Senator BAUCUS. I have a question for either of you. It is in regards to the exhaustion of administrative remedies. Let's assume a taxpayer feels that the Service was wrong, and sits down with an agent. The agent says, OK, I want information in areas "A," "B," "C," "D," and "E." The taxpayer comes back and has all the information that the agent asked for in "A," "B," "C," "D," and "E" areas. After the meeting is over, the agent said before I make a decision, I need information in the areas of "X," "Y," and "Z," plus more information in "A," "B," and "C." The taxpayer is very disgruntled. Gosh, I gave you all you wanted, but, OK, I will do it.

He comes back and gives the agent all the information. At the end of that meeting, the agent asks for more information. We are still in the first stage of the process here.

Would the Service then be acting unreasonably?

Commissioner EGGER. Senator Baucus, I couldn't possibly answer that question unless you tell me how completely the——

Senator BAUCUS. I am assuming that in each of those first two meetings, the taxpayer gave all the information requested of him by the agency.

Commissioner EGGER. Well, if he gave all the information in areas "A," "B," and "C," then there is no way the Revenue agent could ask him for more of it.

Senator BAUCUS. If there's a way, I'll——

Commissioner EGGER. There's no sense beating about the bush about it. Of course, people act in over-zealous fashion from time to

time. It happens with taxpayers; it happens with Revenue agents. We've got 50,000 people out there dealing with taxpayer issues. And 50,000 people or 50,000 human beings—now and again, they will either become overzealous or they will make a mistake.

Senator BAUCUS. But in answer to my hypothetical, then, you think the Service be acting.

Commissioner EGGER. That could happen. That would be a——

Senator BAUCUS. The taxpayer would be reasonably exhausted in terms of administrative application?

Commissioner EGGER. That could happen.

Secretary CHAPOTON. Senator Baucus, I might add that—you are talking about the levels of administrative appeal. I think most complaints come from taxpayers' representatives that there are enough levels of administrative appeals. In other words, they like the administrative route. It's cheaper. It's less formal. And they would like another chance to argue their case at the administrative level. So I think the complaints would come not that there are too many but, indeed, there are not enough. Taxpayers cannot ordinarily complain about not being able to get to the Tax Court in time. They complain about not having sufficient administrative relief.

Senator BAUCUS. Thank you both, very much.

Senator GRASSLEY. Thank you.

Our next panel consists of two people. Mr. Michael Coleman, church administrator for Mobile, Ala., and Mr. Leonard J. Henzke, Jr., tax counsel for the Shriners Hospital for Crippled Children.

Would the two of you come? And I would ask that Mr. Coleman be the first.

STATEMENT OF MIKE COLEMAN, ADMINISTRATOR, GULF COAST COVENANT CHURCH, MOBILE, ALA.

Mr. COLEMAN. It is a privilege to be here today. I would request that my written testimony be made part of the record. I also have a brief oral opening statement that summarizes the points I would like to make.

Senator GRASSLEY. I would like to have you keep your formal remarks and summary to 5 minutes, if you would, please.

Mr. COLEMAN. Yes, sir.

Senator GRASSLEY. Thank you.

Mr. COLEMAN. Mr. Chairman and members of the committee, I am honored to have the opportunity to appear before you today. I am here to represent the interest of the taxpayer in this pending legislation.

I support S. 1673, and recommend that it become law to afford taxpayers greater due process from their Government.

I am the financial administrator of Gulf Coast Covenant Church, a local Christian church in Mobile, Ala., consisting of approximately 1,200 members. My purpose in appearing before this committee today is to assist the Federal Government, the Internal Revenue Service, in particular, and the church at large in more clearly defining our respective roles in American society. It will probably be necessary to pass definitive legislation for this to be accomplished.

My presence here is the result of nearly 3 years of interaction with the Internal Revenue Service. This interaction encompassed

an onsite audit of my church which covered 5 years of activity and took a full 5 weeks to complete, with as many as three IRS agents present at times. In addition, further interaction consumed hundreds of man-hours and over $100,000 in costs to the church. Our interaction with the IRS ended in our church's complete exoneration and a clean bill of health.

I am not here to attempt to recover our financial losses. Rather, I am here to give positive input to the Congress so that other churches can avoid in the future the kind of unwarranted pain and expense that we experienced. All that this painful and expensive investigation by the Internal Revenue Service proved was that we were a legitimate Christian church, something we knew all along.

We went through a preexamination stage with a number of questions being asked of us, which finally ended in the onsite audit. We found through the Freedom of Information Act that the IRS had concealed stolen internal documents from our church, documents we never knew were missing. These documents, which the IRS held from us for almost 3 years, appeared on the surface to be prejudicial against us. However, in the audit, all questions with regard to these documents were satisfactorily answered. Nevertheless, we were never notified by the IRS that they held these documents in their possession. It was only through the Freedom of Information Act that we discovered this.

It is our understanding, there are three foundational principles in our criminal justice system: A speedy trial, presumption of innocence of the accused until proven guilty, and the notification of the accused of the charges against him. Granted that we were not under criminal proceedings, we were not even afforded the rights that certain criminal proceedings afford.

It took 2½ years to declare our innocence. They approached us with a presumption of our guilt from the beginning, and never notified us of their specific concerns about us. It is regrettable that this audit occurred because it could have been avoided. It cost us over $100,000 to defend our innocence.

I believe that S. 1673 will be a means to provide the type of legislative action that is needed to assure that a taxpayer has the proper recourse to defend himself against unreasonable and unjustified action on the part of the Federal Government.

That concludes my opening statement.

Thank you.

Senator GRASSLEY. Thank you. Before we ask questions, we will proceed with you.

Mr. HENZKE. Yes, Mr. Chairman. I have a written statement to submit for the record.

STATEMENT OF LEONARD J. HENZKE, JR., TAX COUNSEL FOR THE SHRINERS HOSPITAL FOR CRIPPLED CHILDREN

Mr. HENZKE. Mr. Chairman, Mr. Baucus, my name is Leonard J. Henzke, Jr., and I am tax counsel for the Shriners Hospitals for Crippled Children of Tampa, Fla.

First, let me give some background information on the work of the Shriners hospital, and the organization's litigation assistance program.

The Shriners Hospital for Crippled Children is a tax exempt charitable organization which operates 21 hospitals in cities across the United States. It has a total of about 1,000 beds. The purpose of this charity is to furnish free hospital care to children. Each of the Shriners hospitals furnishes top quality medical care to children at absolutely no cost to the parents of the children or to third parties. Last year, the hospitals treated about 17,000 orthopedic inpatients and outpatients at an average cost of about $4,700 per child. And about 1,300 inpatients with burns at an average cost of almost $11,000 per child. The Shriner hospitals operating budget is over $69 million a year, and capital projects in progress are estimated to run over $110 million in the next few years.

All of these capital and operating costs of the Shriners hospitals are funded completely by contributions from the general public. Indeed, many people who become familiar with the vital work of the Shriners hospitals choose to donate a substantial portion of their assets through trust and testamentary charitable contributions. Their gifts are the financial lifeblood of the children's medical care furnished by the hospitals.

The interest of the Shriners hospitals in legislative proposals relating to attorney's fees reimbursement stems from this total dependence on charitable contributions. Because of the complexity of the tax laws, trusts and wills of our donors are occasionally drafted in such a way that the charitable deduction for the gift to Shriners hospitals is reduced or disallowed—such as through a disallowance of a charitable deduction for the gift of a charitable remainder. And the increased estate taxes and even the tax litigation expenses themselves are borne entirely by the Shriners hospitals. Of course, many other charities have similar interests, such as ours in defending the tax disputes of our donors with the Internal Revenue Service.

Let me turn for a moment now to our specific proposals for legislation. The provisions of the Equal Access to Justice Act recognize this favored status for charitable organizations. The act currently allows all charitable organizations, which are tax exempt under Code section 501(c)(3) to obtain the fee reimbursement provided by the statute, without regard to the net worth of the organization. This provision was inserted because otherwise attorneys' fees would be a deterrent to charities' vindication of their rights. We strongly urge that this legislation be broadened so as to apply to Tax Court litigation. With interest rates in excess of 20 percent, in many instances it is a hardship for the Shriners hospitals and estates in which it has an interest, or donors, to pay the tax first in order to get into the district court or the Court of Claims; yet such prepayment is now necessary in cases where the IRS position appears unreasonable and an attorneys' fees award seems likely.

We would also like to propose that the provision making all exempt organizations eligible for fee reimbursements be clarified so as to insure that the Shriners hospitals will be eligible when it absorbs the costs associated with a controversy between the Internal Revenue Service and the taxpayer or the estate of a taxpayer respecting a charitable contribution deduction. Both Congress and the Supreme Court have consistently recognized that the deductions for charitable contributions in Code sections 170, 642, 2055,

and 2522 represent the core of the congressional tax support for such organizations—far more than the tax exemption for such organizations provided by Code section 501(c)(3). The charitable capacity of an organization is equally diminished, whether it spends its funds to litigate the technicalities and complexities of charitable tax laws relating to the charity's tax status, or whether the litigation pertains to the charitable deduction of the donor. Where the charity is funding the litigation respecting the charitable donor, the size of the donor's assets is irrelevant.

To broaden the statute in this way, we suggest that the Equal Access to Justice Act be amended or that any substitute statute contain provisions so as to explicitly cover such charity-funded tax litigation, and to remove any asset limitation on the charity and donor taxpayer involved. Our written statement contains suggested statutory language.

In addition, we have two more proposals. One relates to having the statute cover deposition costs and the other relates to the burden of proof. I will refer to my written statement for a full development of those points.

In conclusion, Mr. Chairman, many of you have probably seen recent newspaper reports pointing to studies showing that the new tax law will result in less charitable giving, particularly large donations. Extensions of attorneys' fees reimbursement legislation as outlined above would be one step toward counteracting this trend. It would also be a salutary incentive for tax administrators to focus on situations involving clear and recognized deduction disallowances, and avoid setting up tax deficiencies on the basis of hypertechnical legal analysis.

Thank you, Mr. Chairman.

Senator GRASSLEY. Thank you very much. I appreciate you staying within the time limit.

Mr. Henzke, if we would allow your organization to recover attorney's fees under this legislation, how could we deny award of attorneys' fees to other interested parties who either appear or file or——

Mr. HENZKE. Well, Mr. Chairman, I think the situation with regard to charities who are the recipients of the State and gift charitable contributions is different from the situation that you mentioned.

Since in the case of a charitable beneficiary, virtually all of the litigation expenses come directly out of the gift to the charity. The charity is, in fact, paying litigation expenses of the donor whether it actually hires an attorney to represent the donor or the estate or whether it simply gives some sort of support to the donor of the estate. So I think the situation is much different because it is coming out of the charity's pocket directly. Where in the case you mentioned, a friend of the court, the other party may simply be interested in the litigation; the litigation may have some ancillary affect upon the individual who filed the brief.

Senator GRASSLEY. I'm sorry. I didn't make my question clear then. The question was, Where do we draw the line between your organization, desiring this sort of light under the statute and other interested parties? In other words, where do you draw the line between individuals—individuals now who have that right, and

then extending it to organizations? You are appearing for one organization: every organization would desire this tax treatment.

Mr. HENZKE. Well, our proposal would cover all 501(c)(3) organizations who participate in litigation respecting the deductibility of gifts by donors and estates who are making contributions to that organization. So I think it is really quite limited in scope—the proposal we are making.

Senator GRASSLEY. You are limiting it to the 501(c)(3) organizations?

Mr. HENZKE. 501(c)(3) organizations, yes.

Senator GRASSLEY. A question of both you, Mr. Coleman, and Mr. Henzke. Would S. 1673 or S. 752, if enacted, have enabled you to recover some of the costs you incurred in fighting the IRS? Mr. Coleman.

Mr. COLEMAN. I believe it would have in our situation.

Senator GRASSLEY. It would have?

Mr. COLEMAN. Yes, sir.

Senator GRASSLEY. Do you think the threat of an additional $5,000 penalty for unwarranted delay or bad faith would provide an added incentive for administrators within the IRS to carefully supervise the acts of their agents?

Mr. COLEMAN. Yes, sir, I do. Our experience indicated that the lower echelon agents were the ones with whom we had the most difficulty. Once we got to the district level where you had a greater level of competency in the counsel's office and district director, our case was dealt with and we had our exempt status upheld for the whole 5 years that we were audited.

Senator GRASSLEY. Would you care to comment on both those questions, Mr. Henzke?

Mr. HENZKE. In the case of the Shriners Hospitals, I believe this legislation—well, actually, under the Equal Access of Justice, we have seen influences already——

Senator GRASSLEY. All right.

Mr. HENZKE. Where the threat of the attorneys' fees reimbursement may have caused the Internal Revenue Service to go back and look again at the position they have taken in a particular case in determining whether their position had some basis in the statute of regulations or in some sort of authority. And I am confident that that would take place more in the future.

In most instances, the Service does have a basis for the position it has taken. And it is a well reasoned basis. I was in the Justice Department for many years, and certainly I saw many of those well reasoned bases coming over in memoranda from the Internal Revenue Service. But, occasionally, we would get a case where it was just made out of whole cloth, and where it was a hypertechnical position. And I think in those instances the Internal Revenue would be motivated to take a closer look. And I think that's in the interest of sound tax administration.

Senator GRASSLEY. In your opinion, would a change to the bill requiring both the taxpayer and the IRS to make a full and timely disclosure of all relevant facts be a good condition or a good addition to this bill?

Mr. COLEMAN. In our particular situation, that was our frustration. We had made a timely disclosure of all the facts that were

necessary and they dragged it out for 2½ years. So, for a taxpayer that is honestly trying to cooperate and fulfill the laws applicable to him, shouldn't post too much of a constraint on him to have to produce relevant records in a timely manner in dealing in good faith with Internal Revenue. But, the same requirement should be on the Internal Revenue as well as illustrated by the stolen documents in our case.

Senator GRASSLEY. When I was visiting with you, you said that you often had difficulty complying with the Government's request. One of the problems that you had was that you really didn't know what the Government wanted.

Mr. COLEMAN. Yes, sir, we received two sets of questions. One was 20 questions in length. And the other was 15. We had already received exempt status as a church on two different occasions. One to cover churches that are associated with us under a group exemption status. Our answers to these questions that the IRS asked us were as open and honest as we knew how to be including our sending them a copy of our 1978 financial statement. We even offered to fly to Jacksonville, Fla., to meet with them because we couldn't understand what they wanted.

Senator GRASSLEY. But would a provision of this nature have prevented the concealment of documents—the problem that you outlined in your testimony?

Mr. COLEMAN. Yes, sir. I definitely believe it would have. In fact, in visiting with the District Counsel of the IRS in Atlanta, I specifically asked him how in the world could Internal Revenue have received stolen internal documents and kept them for three years and never notify the church that the IRS had them. He said Mr. Coleman, if you were an attorney and your client came to you with stolen documents, what would you tell him to do? What he was saying was, when he got word of it, he made the agents give them back but it happened only 5 days before our audit occurred. We knew all along that they were not being honest with us and that they were not believing our answers. But we didn't know why until we learned they had stolen documents.

Senator GRASSLEY. Would this give the Service a better way of knowing if the agents were dealing outside the scope of their authority?

Mr. COLEMAN. I believe it would.

Senator GRASSLEY. Senator Baucus had to leave. I have no further questions. Do either one of you have anything you want to say in closing before I call the next panel?

[No response.]

Senator GRASSLEY. I thank you both very much for your help in analyzing this legislation.

Mr. COLEMAN. Thank you.

Mr. HENZKE. Thank you.

[The prepared statements of the preceding panel follow:]

Testimony of Mike Coleman
Before the Subcommittee
on Oversight of the Internal Revenue Service
of the Committee of Finance of the United States Senate

October 19, 1981

Mr. Chairman, members of the committee, I am honored to have the opportunity to appear before you today. I am here to represent the interest of the taxpayer in this pending legislation. I support S. 1673 and recommend that it become law to afford taxpayers greater due process from their government.

I am the financial administrator of Gulf Coast Covenant Church, a local Christian church in Mobile, Alabama, consisting of approximately 1200 members. My purpose in appearing before this committee today is to assist the federal government (the Internal Revenue Service in particular) and the Church at large in more clearly defining our respective roles in American society. It will probably be necessary to pass definitive legislation for this to be accomplished.

My presence here is the result of nearly three years of interaction with the Internal Revenue Service. This interaction encompassed an on-site audit of my church which covered five years of activity (1975-1979) and took a full five weeks to complete, with as many as three Internal Revenue Service agents present at times. In addition, further interaction consumed hundreds of man-hours and over $100,000 in costs to the church. Our interaction with the Internal Revenue Service ended in our church's complete exoneration and a "clean bill of health".

I am not here to attempt to recover our financial losses. Rather, I am here to give positive input to the Congress so that

other churches can avoid in the future the kind of unwarranted pain and expense that we experienced. All that this painful and expensive investigation by the Internal Revenue Service proved was that we were a legitimate Christian church - something we knew all along.

The First Amendment of the Constitution is clear in its prohibition of any hindrance of the free exercise of religion or the promotion of the establishment of any religion. It has been the United States Government's policy that the least restrictive means for the government to interface and interact with churches is to afford them a tax-exempt status, thereby fulfilling First Amendment restrictions in the Constitution. However, recent Supreme Court decisions broadening the meaning of religion to include non-theistic philosophies, such as secular humanism, have complicated the whole realm of tax-exempt laws that relate to churches. (see John W. Whitehead,"The Establishment of The Religion of Secular Humanism and It's First Amendment Implications,"10 Texas Tech Law Review 1 (1978)).

The recent proliferation of all types of religious groups have also compounded the problem. With this proliferation of new religious groups have come blatant abuses of the tax laws applicable to churches in the United States. The abuse of these laws has heightened the government's interest in overseeing and investigating churches, a stance contrary to their previous posture of non-involvement. One can see from the outset that this is a very sensitive area and one which cannot be easily resolved.

I readily acknowledge the responsibility of the Internal Revenue Service to oversee tax-exempt organizations and the various problems that arise from them. However, it's unfortunate that the Internal Revenue Service cannot see the effects of their actions from the perspective of these organizations and taxpayers who go through I.R.S. audits. If they could, it would temper their now inconsiderate actions. The user of a product can always tell the manufacturer ways that the product can be improved because the consumer has the experience of using the product in the real world and not in a testing laboratory.

At this point, I would like to outline a brief procedural overview of how the Internal Revenue Service audits a church. Church audits occur under section 7605(c) of the Internal Revenue Code. Whether by informant information, a referral from a field examination of an individual by a revenue agent, or by some other means, the Internal Revenue Service will initiate proceedings against a church. It begins with pre-examination, which consists of written communications between the Internal Revenue Service and the church. The regulations under 7605(c) and the Internal Revenue Manual 7(10)70 are the two sources of procedure and authority used by the I.R.S. in this process. This pre-examination process can take up to six months and sometimes longer. At the conclusion of the pre-examination stage, the pre-examination agent may then request that the Regional Commissioner grant authority for a field examination to be conducted on the church.

The Regional Commissioner then approves or disapproves the request.

If he grants authority to do an audit, he will issue a letter notifying the church that it will be examined by an Exempt Organizations specialist and that it has thirty days before the agent will be in contact with it to schedule the dates for the audit. At this point, the I.R.S. tells the church not only to have books of account available, but also minutes, correspondence, contributors lists, etc. In other words, every operational document of the church must be available.

Our church, Gulf Coast Covenant Church (formerly known as Gulf Coast Fellowship) was formed in 1972 with 80 members as a Bible-believing Christian church. We were granted exempt status as a church in a determination letter from the I.R.S. on March 29, 1973. By the end of 1975 the church membership had increased to approximately 600 members in the local area with other churches in other parts of the country associating with us. Therefore, we applied for an exemption letter to cover our subordinate churches. This exemption was granted on March 31, 1976.

We have been a church that has attempted to pioneer New Testament concepts and what we see a Christian church should be. Our theology is in the mainstream of historical Christianity and is evangelical in posture.

Over the years, we have had several attorneys counsel us on various matters. One attorney who has advised us has been Mr. John Heard of the law firm of Vinson and Elkins of Houston, Texas. Had

it not been that he provided his services gratis, we would not have been able to afford such excellent legal advice. Also, it had been our standing policy to write the Internal Revenue Service directly when we had questions on tax procedures. Previously, we had asked for and received technical advice from the National I.R.S. office on several matters. In summary, ours was a posture of openness and honesty with the I.R.S.

In keeping with this posture, in January 1979, we wrote to the I.R.S. updating them on our current status and asking several questions. None of those questions were specifically answered.

Then, quite unexpectedly, in March, 1979, we received twenty questions from the I.R.S. in Jacksonville, Florida, with notification that we had thirty days to answer them. These questions took us totally by surprise; we had no idea of their purpose or their implications, nor was there any information provided by the I.R.S. as to the reason for the inquiry. We answered their questions to the best of our ability, formulating ten pages of answers, various exhibits and newspaper articles about our church. We even enclosed a copy of our 1978 financial statement. We stated in the cover letter to these questions that our desire was to comply with the laws applicable to our church. However, our legal counsel and the church had serious concerns about some of the questions asked of us. Some of their questions applied to private foundations and not churches and others raised serious questions about the constitutionality of the I.R.S.

questionnaire since it dealt with theological issues.

Then, in June, 1979, we received another fifteen questions. It seemed evident that, for reasons unknown to us, the I.R.S. did not believe our answers to the first set of questions. They asked about ordination requirements, and we gave them our requirements based upon biblical principles which we have established for our ministers. Then, as if disregarding the validity of these requirements, they asked for the educational requirements for ordination. They asked for a list of substantial contributors, a list of the five highest paid employees and the amounts they are paid, and other questions that indicated to us their mistrust of the integrity of our church operations. Our continuing frustration was that they would never specifically address the legal and/or factual points in question. Neither would they allow us conference rights in Jacksonville, Florida, in order to determine what they wanted. They were approaching us as if we were guilty before we ever even had a hearing or had an opportunity to present any pertinent facts to them.

Finally, in November 1979 (eight months later) we received a letter from the Regional Commissioner, Mr. Harold McGuffin in Atlanta, informing us that the I.R.S. intended to do an on-site audit of our church. In the letter of notification for the audit he asked for the minutes, contributors list, correspondence files, books of account, bank records and other similar information. After this letter we saw the seriousness of the situation and that it would be a long-term encounter with the Internal Revenue Service. We

responded to the Regional Commissioner by letter stating that we would only allow the audit under protest and that we would not disclose the minutes or contributors list.

For six months after the date of this Regional Commissioner's letter we wrote the I.R.S. requesting that the church be notified of the specific reasons for the audit, what issues were being questioned and what years of church business they intended to audit. We were never notified of the specific reasons for the audit nor how the audit would be conducted. It was only after six months and three letters and numerous phone calls that we found out they intended the audit for the years 1975 through 1979. This notification came only six weeks before the actual audit was to occur.

The auditing agent scheduled three different dates as dates that the audit would begin. However, all of these dates were subsequently changed. As a result of this, the schedules of both the church and its pastors were severely disrupted. Finally, on June 2, 1980, six months after we were notified that we would be audited, the audit started and lasted five weeks, with as many as three I.R.S. agents present at one time.

During the five-week audit of the church, we gave the I.R.S. over 1100 copies of documents. We signed numerous sworn affidavits and did everything else we knew to do to answer their questions. They went through just about every transaction that our church had had in the five year period they were investigating. Needless to say, it was a very, very thorough audit on the part of the I.R.S.

Right in the middle of the audit the agent suspended the audit to go on his vacation, saying he did not know when he would be back to finish it. This greatly frustrated us because we had been trying in every possible way to have this audit concluded so we could give ourselves to more positive church activities. This whole Internal Revenue Service entanglement with our church prevented us from moving forward with many church activities. We could not implement a retirement plan for our ministers, purchase property for our church needs, or emphasize growth in our outreach publication ministries because we did not have the financial resources to defend ourselves and also expand our ministry in these ways. In fact, we could not have defended ourselves as we did had we not had numerous other churches which contributed to help defray our defense expenses.

The deleterious effects of this encroachment by the I.R.S. upon our church cannot be adequately conveyed in this paper because it is larger than the sum total of the parts that I describe. They were haughty and high-handed. They failed to answer our calls or respond to our correspondence. They misrepresented the facts to us on numerous occasions and were evasive. They were unresponsive to several Congressmen, Senators and Administration officials who attempted to determine the real purpose of their procedures against our church. We continually found ourselves with no real recourse to solve the problems and had to continue to fight this ordeal through the slow and unresponsive bureaucratic system of the I.R.S.

Subcommittee Testimony
Mike Coleman
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Back in December, 1979 after nine months of unsuccessfully trying to determine charges or allegations against us, our attorneys filed a Freedom of Information Act request with the I.R.S. We felt that there must be something or someone prejudicing the I.R.S. against us.

After our Freedom of Information Act request was handled very irresponsibly, we appealed in April 1980 to the national office for an administrative review of our request. Then, five days before the actual audit occurred, we found out that the I.R.S. had concealed stolen internal documents of our church. It was not until late May, 1980, that the I.R.S. returned internal documents of our church to us that they had held in their possession for nearly three years.. These documents allegedly were turned in to the Internal Revenue Service by an anonymous informant. Needless to say, our attorneys and our church were completely shocked. The fact that the I.R.S. initiated this audit against us and never told us that they held in their possession stolen internal documents of our church heightened our sense of the injustice of their actions.

What makes it even worse is that we had made a Freedom of Information Act request and an administrative appeal to the national office of the I.R.S. and they had still not informed us of these documents. As our attorneys and I reviewed the documents it became very apparent why the I.R.S. would want to look into our church. The documents that were stolen and turned in to the I.R.S. were presented in such a slanted way as to arouse suspicion concerning the activities of

our church. These stolen documents consisted of offering envelopes and cancelled checks. We do not object to the fact that the I.R.S. inquired or that they had a right to inquire. In fact, if they had been honest with us we would have only had to go through about 35% of the process that we went through and we could have settled all issues to the satisfaction of the Service and the church. In fact, once we had an opportunity to answer the questions in the audit that were generated by these documents, the issues were resolved to the satisfaction of the I.R.S., since the documents were then considered in the total context of our church activities.

We readily acknowledged that the I.R.S. has a legitimate function that they need to perform in overseeing tax-exempt organizations. However, the way in which they handled these documents and other aspects of this audit greatly concerns us.

We know that the I.R.S. has violated its policy norms in the audit of our church based upon numerous comments from our attorneys, one of whom is the former Regional Counsel for the I.R.S. in the mid-Atlantic region, Mr. Bob Liken. Mr. Liken retired in the early part of 1980 and began to work with various churches and other tax-exempt organizations regarding their tax problems. When he became involved in our case he was so appalled at the way the I.R.S. had treated us that he wrote a letter to Mr. Harold McGuffin, the Regional Commissioner, telling him that he had better investigate the way in which our audit had been conducted for the good of the church and for the good of the Service. Mr. Liken in his letter to Mr. McGuffin stated (and I quote):

"This is a bona fide, evangelical, basic Bible-believing Christian church in Mobile. Many of us consider it may be the prototype of the evangelical church of the future. Despite its bona fide credentials, an agent has given it a full field investigation and I would not be surprised if the agent has 1,000 man-hours in the case. The investigation is considerably outside policy norms for a church."

Mr. Liken is now chief counsel for the State Department of Revenue for the State of Pennsylvania. In view of his comments, our other attorney's comments and what we knew from our own personal experience, we had ample reason to believe that there had been numerous violations of the law in the way that our case had been handled.

After the audit was over we filed suit in October of 1980 in Federal Court against the I.R.S. under the Freedom of Information Act, because it was very apparent that they had not dealt honestly or legally with us in this matter. The Justice Department sent one of their attorneys to Mobile to discuss the case with us. When we challenged them on the legal issues involved they dropped opposition to one of our motions for a Vaughn Index of the rest of the documents remaining in the file and ultimately we settled out of court. We then found that they had not returned all the original documents to us. In fact, they gave us another copy of our 1975 financial statement which we had already given to the agents six months before in the audit.

It is evident from the Freedom of Information Act documents that the I.R.S. used the stolen information and other information to compile a list of individuals and organizations associated with our church

with a view to initiate audits on them.

We cannot prove this with 100% certainty but the preponderance of evidence indicates that the three audits on individuals which were conducted were directly a result of the audit on the church. I was audited in 1979 after I had listed myself as the man to contact on the pre-examination questions. Our main attorney, Michael Ford, was audited shortly after he filed a power of attorney to represent the church before the I.R.S., and then in the Spring of 1981 another admistrative staff member was audited. The result of all of these three individual audits was that either there were refunds issued to the audited individual or a small amount of tax was paid (under $100.00). So, it is obvious that none of the staff had been engaged in any illegal activity rendering these personal audits, in my opinion, strictly a form of harassment.

It took the I.R.S. one year to make a decision on the result of our church audit. Even though we came out of this whole process with our exempt status intact, these proceedings have had an extremely deleterious effect upon all of us who have been involved with them. We believe that the cumulative effect of all that happened to us is an infringement on our Constitutional rights as a church. The sheer length of the inquiry alone has punished and detered our church from its constitutionally recognized pursuit of religious freedom.

This entire incident doesn't really have any winners. We, as a church, lost a great deal and so did the I.R.S. Our church lost a great deal of confidence in our government because of this audit.

We had approached our government with openness and honesty but we didn't find them reciprocate with the same attitude.

It cost us over $100,000 to defend our innocence. Having this cloud of investigation hanging over our church for two and a half years damaged our reputation and dignity. The mental tenseness and anguish we experienced through this ordeal was something I would never wish on someone else. It affected the forward motion and direction of our church, delaying implementation of some plans for several years. It also cost us hundreds of man-hours, finally necessitating that my job responsibilities be adjusted so that I could handle this on a full-time basis.

It also cost the I.R.S. a great deal. It cost them and the Justice Department a great deal of money and man-hours to pursue this over almost three years only to find us innocent. They lost the confidence of a constituency who sought to deal with the government as an agent they believe to be ordained by God. They have lost the confidence of the larger Christian community as the result of other positions they have taken on similar issues. They may well have also lost some self-esteem, because they could not possibly feel proud of the treatment afforded our church.

It is regretful that this audit occurred because it could have been avoided. My concern is for the small church or the taxpayer with little resources to defend themselves. I wonder if there is true "poor man's justice" any more because for a private citizen or

small organization to defend their rights against the power and complexity of the federal government, they must have enormous resources to retain attorneys, other legal assistance and the ability to fund hours of work and research.

I trust that my testimony has served the purpose of more clearly defining the respective roles of the government and the Church. I hope greater effort will be given by the Congress and the I.R.S. to remedy the problems outlined in my testimony. I believe that S. 1673 will begin to provide the type of legislative action that is needed to assure that a taxpayer has proper recourse to defend himself against unreasonable and unjustified action on the part of the government.

Mr. Chairman, I appreciate your courtesy in allowing me to testify. Thank You.

STATEMENT OF
SHRINERS HOSPITALS FOR CRIPPLED CHILDREN
TAMPA, FLORIDA
BEFORE THE
SENATE COMMITTEE ON FINANCE,
SUBCOMMITTEE ON OVERSIGHT OF THE
INTERNAL REVENUE SERVICE,
RECOVERY OF ATTORNEYS' FEES IN TAX CASES

October 9, 1981

Mr. Chairman, members of the Subcommittee on Oversight of the Internal Revenue Service. My name is Leonard J. Henzke, Jr. one of the tax counsel for the Shriners Hospitals for Crippled Children of Tampa, Florida. I very much appreciate the opportunity that has been afforded to present the views of the Shriners Hospitals for Crippled Children on the subject of legislative proposals relating to payment of attorneys' fees in tax litigation.

I. Background--the work of the Shriners Hospitals

The Shriners Hospitals for Crippled Children is a tax exempt charitable organization which was founded in 1922. It operates 21 hospitals in cities across the United States, with a total of about 1000 beds. The purpose of this charity is to furnish free hospital care to children. The hospitals specialize in treating children with severe burn injuries and with orthopedic problems.

Each of the Shriners hospitals furnishes top-quality medical care to children at absolutely no cost to the parents of the children or to third-parties. The hospitals receive no reimbursement, either from any level of government or from health insurance carriers. Last year, the hospitals treated 17,331 orthopedic inpatients and outpatients at an average cost of $4792 per child, and 1363 inpatients with burns at an average cost of $10,925 per child. The Shriners' Hospitals' operating budget is over $69 million per year, and capital projects in progress are estimated to run over $110 million in the next few years.

II. Attorneys' fees reimbursement will substantially benefit the charitable contributions program of Shriners Hospitals

All of these capital and operating costs of the Shriners Hospitals are funded completely by contributions from the general public. Indeed, many people who become familiar with the vital work of the Shriners Hospitals choose to donate a substantial portion of their assets through trust and testamentary charitable contributions. Their gifts are the financial lifeblood of the children's medical care furnished by the Hospitals.

The interest of the Shriners Hospitals in legislative proposals relating to attorneys' fees reimbursement stems from this total dependence on such charitable contributions. With the enactment of the Tax Reform Act of 1969, the federal tax laws relating to the deductibility of charitable contributions became

exceedingly complex, involving matters such as charitable remainder annuity trusts, unitrusts, pooled income funds and other related gifts of partial interests in property. Because of the law's complexity, trusts and wills of our donors are occasionally drafted in such a way that the charitable deduction for the gift to Shriners Hospitals is reduced or disallowed--such as through a disallowance of a charitable deduction for the gift of a charitable remainder--and the increased estate taxes are borne entirely by the Shriners Hospitals. Indeed, often under such instruments the litigation costs arising from the charitable deduction reduces the gift to the Hospitals dollar for dollar. For these reasons, it is vitally necessary for the Shriners Hospitals to provide legal assistance to the donor's estate in litigation over its charitable contribution deduction.

Moreover, our litigation assistance, at no cost to the charitable remainder trust, inevitably encourages further contributions; it also gives the Shriners Hospitals a measure of control in determining the legal arguments to be made by tax counsel who can specialize in these controversies and who have previously litigated similar issues on behalf of the charity. Since a technical tax issue in litigation will frequently affect many current or potential charitable donors, it is very important to the Shriners Hospitals that its lawyers have input into the tax

litigation. In some instances, for example, such litigation may involve the initial judicial interpretation, or the constitutionality, of tax legislation which is vital to the entire deferred giving program of the Shriners Hospitals. See, e.g., First Nat. Bank of Oregon v. United States, 571 F.2d 21 (Ct. Cl. 1978). Indeed, in some tax cases involving the charitable estate tax deduction it has litigated the same issue across the country seeking the most favorable forum. See, and compare, Merchants National Bank v. United States, 583 F.2d 19 (1st Cir. 1978) with Shriners Hospitals for Crippled Children v. United States, 602 F.2d 302 (Ct. Cl. 1979). See also, Wells Fargo Bank, N.A. v. United States, ___ F. Supp. ___, 44 AFTR 2d 79-6195, 1979-2 USTC ¶13,317 (N.D. Cal. 1979). Of course, many other charities have similar legal assistance programs respecting the deductibility of their donors' contributions, so their interests coincide with ours.

III. Charities' need for attorneys' fees reimbursement legislation is growing more acute

In providing quality medical care to children without cost, the Shriners Hospitals is performing a quasi-Governmental activity. Long ago the Ways and Means Committee recognized that the allowance of charitable contribution tax deductions was justified by the governmental work done by charities (H.R. Rep. No. 1820,

75th Cong. 3d Sess. 19 (1939)):

> The exemption from taxation of money and property devoted to charitable and other purposes is based upon the theory that the Government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare.

Over the years since that statement, rising federal taxes have eroded the income available to support private charities, and it has become more essential that donors be able to provide support with before-tax dollars. At the same time, funds available for charity have been further diminished by the fact that donors and charities must pay greater legal fees as a result of the complexities of the charitable contribution deduction laws. Moreover, skyrocketing medical costs are putting increasingly greater demands on our hospitals. In these circumstances, it is reasonable for the Government to bear at least part of the financial burden we and all other charities sustain in presenting such tax issues to courts for judicial interpretation and resolution.

IV. Specific proposals

1. The provisions of the Equal Access to Justice Act recognize this favored status for charitable organizations. As you know, the Act currently allows all charitable organizations

which are tax exempt under Section 501(c)(3) of the Internal Revenue Code to obtain the fee reimbursement provided by the statute, without regard to the net worth of the organization. This provision was inserted because otherwise attorneys' fees would be a deterrent to charities' vindication of their rights. H.R. Rep. No. 96-1418, 96th Cong. 2d Sess. 15 (1980). This is certainly true in the case of the Shriners Hospitals, where their average cost for treating a child can run as high as $11,000, so that each $11,000 spent on attorneys' fees to encourage and protect contribution support means the loss of the capability to treat a needy child.

We strongly urge that this legislation be broadened so as to apply to Tax Court litigation. With interest rates in excess of 20 percent, in many instances it is a hardship for the Shriners Hospitals and estates in which it has an interest, or donors, to pay the tax first in order to get into the District Court or the Court of Claims; yet such prepayment is now necessary in cases where the I.R.S. position appears unreasonable and an attorneys' fees award seems likely.

2. We would also like to propose that the provision making all exempt organizations eligible for fee reimbursements be clarified so as to ensure that the Shriners Hospitals will be eligible when it absorbs the costs associated with a controversy between the Internal Revenue Service and the taxpayer or the

estate of a taxpayer respecting a charitable contribution deduction. Both Congress and the Supreme Court*/ have consistently recognized that the deductions for charitable contributions in Code Sections 170, 642, 2055, and 2522 represent the core of the Congressional tax support for such organizations--far more than the tax exemption for such organizations provided by Code Section 501(c)(3). The charitable capacity of an organization is equally diminished, whether it spends its funds to litigate the technicalities and complexities of charitable tax law relating to the charity's tax status, or whether the litigation pertains to the charitable deduction of the donor. Where the charity is funding the litigation respecting the charitable donor, the size of the donor's assets is irrelevant to the adverse impact of the litigation costs on the charity. And the charity must also concern itself with the "ripple" effect of adverse IRS actions or court decisions.

To clarify the statute in this way, we suggest that the Equal Access to Justice Act, 5 U.S.C. §504(d)(1)(B), be amended so as to explicitly cover such charity-funded tax litigation, and so as to remove any asset limitation on the charity and donor

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*/ In Bob Jones University v. Simon, 416, U.S. 725 (1974) and Alexander v. "American United" Inc., 416 U.S. 752 (1974), the Supreme Court recognized that most charities depend on the tax deductibility of contributions for their financial well-being, and indeed in many cases for their very existence. Congress has recognized this same fact in enacting Section 7428 of the Internal Revenue Code, which permits a charity to obtain an expedited declaratory judgment as to its eligibility to receive tax deductible contributions.

taxpayer involved. The amended statute would read as follows:*/

> "(B) 'party' means (i) an individual whose net worth did not exceed $1,000,000 at the time the civil action was filed, (ii) a sole owner of an unincorporated business, or a partnership, corporation, association, or organization whose net worth did not exceed $5,000,000 at the time the civil action was filed, except that an organization described in section 501(c)(3) of the Internal Revenue Code of 1954 (26 U.S.C. 501 (c)(3)) exempt from taxation under section 501(a) of the Code [may be] shall be treated as an eligible party regardless of the net worth of such organization, and whether or not it is funding litigation respecting its own tax liabilities or litigation respecting the deductibility to a taxpayer of charitable contributions donated to the section 501(c)(3) organization, and except further that a cooperative association as defined in section 15(a) of the Agricultural Marketing Act (12 U.S.C. 1141j(a)), may be [a] an eligible party regardless of the net worth of such [organization or] cooperative association, or (iii) a sole owner of an unincorporated business, or a partnership, corporation, association, or organization, having not more than 500 employees at the time the civil action was filed; and * * * [Omitted language in brackets, added language emphasized.]

Of course, we would urge that such language also be made applicable to Tax Court actions.

3. We note that S. 752 introduced by Senator Baucus, together with H.R. 1095, H.R. 2555, and H.R. 3262 in the House which

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*/ For purposes of this amendment, "taxpayer" has the same meaning as that in Section 7701(a)(14) of the Internal Revenue Code.

also deal with recovery of attorneys' fees in tax cases--all include no limitation on the size of the eligible taxpayer. We have no position on such an across-the-board omission, but simply urge that if size eligibility limitations are provided, an exception along the lines set forth above be added. Should no size limitation be included, however, we suggest that a sentence be included in the bill making clear that an eligible "party" includes an exempt Section 501(c)(3) organization which funds the litigation costs of a charitable donor respecting the tax treatment of the taxpayer's donation.

4. The Equal Access to Justice Act, together with S. 752 and H.R. 3262, allow reimbursement of fees of attorneys, reasonable expenses of expert witnesses, and the reasonable costs of a necessary study, analysis, engineering report, test or project. In the case of most charitable tax litigation, however, a major expense is that for witness fees and court reporter fees incurred in taking depositions. We urge that language be added to the Equal Access to Justice Act, and any other attorneys' fees recovery statute, which would make clear that the cost of providing witnesses and court reporters incurred in taking depositions be reimbursable.

5. S. 752 (together with H.R. 3262) would shift to the taxpayer the burden of proving that the position of the United States is "unreasonable." Under the Equal Access to Justice Act as

written today, that burden is on the Government. Since the Government's own files will normally contain much of the evidence respecting reasonableness, we think it should have the burden of proof. Otherwise, taxpayers would have to obtain such materials through discovery, which would be time-consuming and expensive, even if the Government consents to access to its files. The burden of proof issue should be dealt with specifically in any legislation which is drafted so that the Government must justify the reasonableness of its actions.

6. The legislative history of any fee reimbursement statute should make clear that attorneys' fees for work done in obtaining an attorney fee award should be included in the same award or a separate award. See, e.g., Perkins v. Standard Oil of California, 474 F.2d 549 (9th Cir. 1973).

V. Conclusion

Many of you have probably seen recent newspaper reports pointing to studies showig that the new tax law will result in less charitable giving--particularly large donations.*/ Extension of attorneys' fees reimbursement legislation as outlined above would be one step toward counteracting this trend. It would also be a salutary incentive for tax administrators to focus on situations involving clear and recognized deduction disallowances, and avoid setting up tax deficiencies on the basis of legal analysis which is superfluous, hypertechnical or not clearly supported by legislative history or prior judicial decision.

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*/ See "The Federal Government and the Nonprofit Sector: The Impact of the 1981 Act on Individual Charitable Giving," a study for Independent Sector by Charles T. Clotfelter and Lester M. Salamon, published by Urban Institute (August, 1981).

Senator GRASSLEY. The next panel consists of Mr. Timothy Holtzheimer, representing the American Institute of Certified Public Accountants, and Mr. John S. Nolan, chairman of the section of taxation of the American Bar Association.

Would you like to start, Timothy?

Mr. HOLTZHEIMER. Thank you, Mr. Chairman. My name is——

Senator GRASSLEY. I'm sorry; we were given the wrong information here. Mike McKevitt. I see you are in the audience and it was meant for you to be on this panel as well.

Mr. MCKEVITT. Thank you, Senator.

Senator GRASSLEY. Yes; thank you very much. Would you start?

Mr. HOLTZHEIMER. Thank you, Mr. Chairman.

STATEMENT OF TIMOTHY HOLZHEIMER, TAX PARTNER, HAUSSER & TAYLOR, REPRESENTING THE FEDERAL TAX DIVISION OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, WASHINGTON, D.C.

Mr. HOLZHEIMER. Thank you, Mr. Chairman. My name is Timothy Holzheimer, and I am a partner in the firm of Hausser and Taylor in Solon, Ohio. I also am a member of the Scope of Management of a Tax Practice Subcommittee of the Federal Tax Division.

For the sake of brevity, I would like to cover the two specific recommendations relative to Senate bill 1673.

First, the AICPA urges the subcommittee to include in reimbursement of fees the cost of administrative appeals to the Internal Revenue Service in this legislation. It is our contention that unless these awards are available in the administrative phase of this dispute between the Service and that of the taxpayer, the taxpayers will be encouraged to bypass their administrative remedies and to pursue litigation in order to obtain attorney reimbursement. We would like to point out that the standards for reimbursement, set forth in S. 1673; namely, a reasonable claim, taxpayers substantially prevailing, and a significant issue factor enables the court, within its discretion, to award fees based on the facts and circumstances to specifically include administrative fees incurred subsequent to the receipt of a 30-day letter from the IRS. This would not add additional expense and complexity to the system of administrative appeals within the Internal Revenue Service.

Second, the AICPA urges the subcommittee to maintain section c(1)(b) of the bill whereby fees of CPA's representing taxpayers before the Tax Court as well as attorney fees are included in the definition of reimburseable fees and costs.

We believe the taxpayers should be free to choose among professionals qualified to represent them before the IRS under circular 230 which permits taxpayers to be represented by attorneys, CPA's, enrolled agents and other representatives before the Tax Court.

This concludes my testimony but I would like to respond to the three amendments that you raised. I do not know the AICPA position on these three amendments, but I would like to add my own personal comments.

As to full disclosure of the facts by the taxpayer and the exclusion of the smalls claims, I believe that would be agreeable with me. As to the reasonable effort test for administrative remedies, I think this underwrites the need, as expressed in my testimony, to

include administrative costs incurred by the taxpayer in going through the administrative procedures.

Those are my comments. Thank you, Mr. Chairman.

Senator GRASSLEY. Thank you.

STATEMENT OF JOHN S. NOLAN, CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION, WASHINGTON, D.C.

Mr. NOLAN. I am John S. Nolan, chairman of the section of taxation of the American Bar Association, an organization of 24,000 tax lawyers throughout the United States. The position of the American Bar Association is that the Tax Court, as well as the U.S. District Court and Court of Claims, should be authorized to award reasonable attorney fees and expenses to a taxpayer who prevails in a civil tax case. Under existing law, under provisions of the Equal Access to Justice Act, which became effective October 1, 1981, attorney fees and expenses may be awarded to a taxpayer in a civil tax case in the U.S. District Court or the Court of Claims under certain conditions. The American Bar Association considers that it should be made clear that such awards should also be made in the Tax Court, and that certain other deficiencies in the Equal Access to Justice Act and in bills which have been introduced to provide for award of attorney fees in tax cases should be rectified.

There is no justification for withholding attorny fee awards in tax cases in the Tax Court while they are being allowed in tax cases in the Federal District Court and Court of Claims. We favor awards in tax cases in all instances under appropriate conditions. The Tax Court is the only forum in which taxpayers may litigate their tax disputes with the Internal Revenue Service without being required first to pay in full the amount of tax the Service alleges to be due. The Tax Court is, accordingly, the place where most taxpayers of moderate means and small businesses seek judicial review of IRS determinations. Exclusion of the Tax Court denies the benefits to the very class of persons whom Congress most wishes to help.

The Equal Access to Justice Act limits attorney fee awards to individuals having a net worth of $1 million or less, to businesses and other organizations with a net worth of $5 million or less having 500 or fewer employees, and charitable organizations and agricultural cooperatives. Bills which have been introduced to provide for attorney fee awards would eliminate this net worth test; S. 752 would substitute a $20,000 cap on such awards, and S. 1673 would apply a cap of $25,000. We strongly prefer a flat dollar limitation, such as the $20,000 or $25,000 cap. Net worth determinations are complex and may embroil the courts in controversies as difficult as the substantive tax issues that were decided.

The Equal Access to Justice Act awards attorney fees and expenses unless the Government demonstrates that its position was "substantially justified" or that "special circumstances would make an award unjust." S. 752 and S. 1673 would, instead, require that the taxpayer prove that the Government's position was not merely incorrect but also "unreasonable." We urge the Congress not to adopt this latter approach. The term "unreasonable" is too vague a standard, and the burden of proof in any case should be on the Government, not on the taxpayer. The reasonableness of the Gov-

ernment's position is more likely to be determined from Government records than from external sources, and if the Government has lost the case, it is fairest and most efficient to require the Government to establish that it satisfies an appropriate standard for allowance of such awards.

We urge, however, that Congress provide more extensive guidelines for such awards. We have included cases in our statement for the record in which awards would be justified and other cases in which awards would not be justified. For example, an award would be justified if the Government has previously lost a final decision on the legal issue in another forum. An award would not be justified where the taxpayer's failure to cooperate in a reasonable administrative investigation left the IRS no choice but to litigate.

We are concerned that such awards will result in fewer administrative settlements of tax cases, and we strongly urge that taxpayers, as a condition for obtaining such awards, be required to make a good faith effort to utilize the IRS appeals procedures before bringing their cases to court. There should be an exception only where the court finds that it would haved been futile for the taxpayer to pursue his administrative remedies in the particular circumstances.

The Internal Revenue Service should be encouraged to take the initiative in proposing settlements in appropriate cases. A taxpayer should be denied an attorney fee award if he refuses a settlement offer as favorable as the court's final judgment unless the case involves a continuing issue which the Service refused to concede in prior years.

The Equal Access to Justice Act provides for an attorney fee award where the person in question is the "prevailing party". This involves some special problems in tax litigation. Tax cases frequently involve more than one issue, and the most significant issue is not necessarily the one involving the most dollars. S. 752 and S. 1673 would clarify this matter in tax cases by defining a "prevailing party" as one who has substantially prevailed either with respect to the amount in controversy or with respect to the most significant issue or set of issues presented. We support this provision.

Could I have 1 more minute, Mr. Chairman?

Senator GRASSLEY. Yes.

Mr. NOLAN. Our position has many common threads with that of the Treasury Department, though we differ at the bottom line. The Treasury Department's basic concern is that the Tax Court's already overburdened docket will be increased even more. There are, however, provisions just enacted in the Economic Recovery Tax Act in 1981 that will have significant effects in relieving that docket. Raising the interest rate on deficiencies to the prime rate, which would mean a rate of 20 percent for 1982, will discourage the taxpayers from taking cases without substantial merit to the Tax Court. So, also the new heavier burden of the negligence penalty and the new overvaluation penalty will discourage nonmeritorious cases. So also will the increased filing fee. Perhaps attention should be given to beefing up the authority of the Tax Court under Code Section 6673 to award damages to the Government against taxpayers who institute proceedings merely for delay.

In the last analysis, however, it is critical to our self-assessment tax system that taxpayers have complete confidence in the fairness of that system. Where a taxpayer has exhausted his administrative remedies, he should be able to litigate the correctness of an IRS assertion that additional tax is due with the assurance that if he prevails, he will recover reasonable attorney fees unless the Government demonstrates substantial justification for its position. This is a reasonable balancing of the interests involved and will contribute greatly to increased taxpayer confidence in the fairness of the system.

Thank you.

Senator GRASSLEY. Thank you, Mike, do you have a statement?

Mr. MCKEVITT. Yes.

STATEMENT OF JAMES D. McKEVITT, DIRECTOR OF FEDERAL LEGISLATION, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. MCKEVITT. Mr. Chairman, my name is Mike McKevitt, appearing as the director of Federal legislation on behalf of the National Federation of Independent Business, representing over half a million small businesses across this country.

NFIB strongly urges the Equal Access to Justice Act be broadened so as to apply to Tax Court litigation.

A taxpayer's decision to litigate his Federal tax liability is usually based on economic considerations. The taxpayer must balance the costs of litigation against the possible tax saving should be or she prevail. The largest single cost of such litigation will likely be IRS practitioner fees. In many cases, these fees will be so high that a taxpayer will be unwilling "to go to the mat" with the Government in order to prove his point, even though the taxpayer may well stand an excellent chance of ultimately prevailing on the merits.

Since the Tax Court is the only forum in which taxpayers may litigate their tax disputes with the IRS without first having to pay the tax which the Service alleges to be due, the Tax Court should be authorized to award reasonable fees for IRS-approved practitioners, as well as expenses for a taxpayer who prevails in a civil tax proceeding. The prime motivation in creating the Tax Court was to provide a forum for taxpayers to litigate the determination of their tax liability prior to payment. For NFIB businesses with inflation-induced financial leverage problems, the Tax Court may very well be the only viable forum for resolving their disputes with the IRS.

Moreover, NFIB supports language that definitively places the standard of proof on the Government to show that they were reasonable or had substantial justification in bringing the case as a condition of fee awards in tax cases.

We've just polled our members on that particular issue. And it came back 2 to 1 in favor of this burden.

The Department of Treasury opposes this legislation as effectively tieing IRS hands as adding an enormous new caseload to a Tax Court whose docket is already severely overburdened. To counter this argument, NFIB proposes that:

First, taxpayers must exhaust the administrative appeals process prior to docketing a case in the Tax Court.

Second, increase damages meted out against taxpayers who institute court proceedings for delay or other unjustified purposes.

Third, strengthen so-called small case procedures.

Fourth, urge the IRS to publish a comprehensive and comprehensible description of the taxpayers' rights and the avenues at his or her disposal to protect them.

Finally, NFIB does not support any cap on amounts recoverable in order to insure that the vast enforcement power of the Federal Government be selectively and prudently exercised.

Senator GRASSLY. Mike, you were commenting on three of the four possible amendments that I suggested?

Mr. MCKEVITT. YES.

Senator GRASSLEY. And you are in support of those?

Mr. MCKEVITT. Yes.

Senator GRASSLEY. Mr. Nolan, why do you believe Congress should develop policy guidelines to administer the standard of unreasonableness instead of giving the Tax Court judges as much discretion as possible?

Mr. NOLAN. I do not favor limiting the Tax Court's discretion in any respect. The Court itself would welcome some indication from Congress either in the statute or in the legislative history as to how the standard was to be applied. We have suggested a number of standards running both ways. It is quite helpful to the court to understand more fully how the standard, whatever standard Congress enacts, is to be applied.

Senator GRASSLEY. Aren't the Tax Court judges in the best position to determine which taxpayers should be awarded attorney's fees and the amounts to be awarded?

Mr. NOLAN. They are in the best position to do so. They have the circumstances before them. But once the standard is adopted, whether it is reasonable or unreasonable, or substantially justified, or whatever, it is always helpful to the court to know the types of cases that Congress has in mind that should result in award and the type that should not.

Senator GRASSLEY. If we place a limit on this bill restricting the recovery of attorney's fees to taxpayers who have made good faith efforts to resolve the dispute by administrative remedies within the IRS, would this satisfy your concerns regarding the impact of this legislation on IRS administrative remedies, Mr. Holzheimer?

Mr. HOLZHEIMER. No. What we would be looking for though, is that that term "reasonable fee" include administrative expenses, those expenses incurred; that is, by the taxpayer going through the administrative levels to the full appeal. Typically, the accountant who has handled the IRS agent's action, and then is asked to go on to appeal, would formulate much time and cost in making the proper presentation to the IRS. And that cost should be considered by the court when it ultimately goes to litigation.

Senator GRASSLEY. Then you desire that attorney's fees and other professional fees be awarded even at the administrative level? And that is what you have testified?

Mr. HOLZHEIMER. Right. That's correct.

Senator GRASSLEY. If that is your position, why shouldn't the IRS be given an opportunity to admit its mistake earlier on without incurring the penalty of reimbursement of attorney's fees?

Mr. HOLZHEIMER. Ultimately, they would do that. We could limit the issues to direct issues and make a settlement at that level.

Senator GRASSLEY. But even at that point, wouldn't your organization's position require some reimbursement?

Mr. HOLZHEIMER. No, Mr. Chairman, it would only start at the point that it went to litigation to the Tax Court, even if it was settled at the administrative level.

Senator GRASSLEY. Then I misunderstood your testimony. I thought that you were asking that costs be awarded, or reimbursement of costs, as you were going through the administrative process.

Mr. HOLZHEIMER. That's correct. But only if it goes to litigation. It always has to go through administrative procedures to appeal; then the taxpayer chooses to go to the Tax Court. At that point in time, if he is successful at the Tax Court level, he accomplishes his standard set forth by the court, and the court makes the determination as to what constitutes reasonable fees. The court could consider accountant fees or other expert fees incurred going through the administrative appeal but only if it got to litigation.

Senator GRASSLEY. Why do you favor reimbursement to taxpayers for the cost of administrative appeals to the IRS rather than requiring a good faith exhaustion of administrative remedies within the IRS—and that as determined by the Tax Court—in order to solve the problem of taxpayers bypassing the IRS administrative remedies in favor of litigation?

Mr. HOLZHEIMER. I don't believe we are opposed to encouraging the taxpayer to go through his administrative appeal. However, there are certain circumstances where a small practitioner has dealt with an IRS agent and has found and unsatisfactory conclusion. And all indications are, by pursuing the administrative appeal, that he may not find any satisfaction there. Therefore, he goes to the Tax Court level.

Administrative appeals take two forms. Either going to the administrative conferee and discussing what the issues are or submitting a written report if the amount in dollars is more than $2,500 with the tax deficiency. Both of these require additional time over and above the examining agent's level in costs incurred to that point.

Senator GRASSLEY. Do any of you have additional statements for the record you want to make? Otherwise, I have finished with my questions.

Mr. NOLAN. I would like to make one additional statement. I did not address myself to your third question—whether a distinction should be drawn between so-called "S" cases, small claims cases, and others. I would urge the Congress to go very carefully in drawing any such distinction. We certainly do not want to discourage use of the so-called "S" docket procedure. If attorney fees awards are made in cases that do not go to that docket but not in cases that do, we could well end up discouraging the use of that docket. It is entirely elective with the taxpayer as to whether he uses the small claims process or not. The arguments are equally strong and maybe stronger for granting attorney fee awards in "S" cases as in other cases. It is really the small taxpayer that we want to focus on here. If he has been required, as we have suggested and

as you have suggested, that his administrative remedies be exhausted first, and then if he goes to the Tax Court, and if he wins his case, it is entirely appropriate that the Government should pay reasonable attorney fees under those circumstances.

Senator GRASSLEY. Thank you. Go ahead, Mike.

Mr. MCKEVITT. Well, I just wanted to add to what Mr. Nolan said. I think probably most of our problems with the Federal Government comes from the Department of Treasury. And most of it IRS. So that is a big cost for us in taking on a lot of these cases. I have some figures here about tax protesters—6 percent in the 8,000 cases; 24 percent, abusive tax shelters. What about the other 70 percent of the cases? A lot of those are our cases. And I hope that you will take that into consideration and pass that along to your colleagues as well.

Another thing I think you ought to point out to your colleagues in the Senate and in the House is the fact—I have served in the Government as a district attorney, Member of Congress, Assistant Attorney General of the United States.

I have seen how all these lawyers working these agencies—they are building their track record so they can go out into private practice. And they will look at a case and, I think, that rather than put a bad faith requirement on it, they will look at it as unreasonable or pursue it, as the gentleman from the American Bar Association pointed out, because I think a lot of this is overzealousness on their part. Not just a poor act of judgment, but a calculated design to take that particular case because it looks attractive on their dossier or on their résumé when they go out into private practice.

And those kind of people are alive and well throughout the Federal Government because they are building their 4 years or whatever they have before they go into private practice. And to have those kind of cases on their track record makes them all that much more attractive when they go into private practice. And on the other receiving end of it—a lot of them are small businesses.

[The prepared statements of the preceding panel follows:]

Testimony of

E. Timothy Holzheimer

Member

Scope and Management of a Tax Practice Subcommittee

American Institute of Certified Public Accountants

Good afternoon! My name is E. Timothy Holzheimer, and I am a partner in the Solon, Ohio CPA firm of Hausser & Taylor. I am a member of the Scope and Management of a Tax Practice Subcommittee of the Federal Tax Division of the American Institute of Certified Public Accountants and am here today representing that organization. The AICPA is the national organization for more than 175,000 CPAs, many of who are involved in tax practice.

The AICPA supports the objectives of the legislative proposals to reimburse fees of representatives in tax controversies. We believe that in many cases such reimbursement is necessary to provide equal representation and justice to taxpayers, and that this is necessary to the fair and efficient operation of our tax system.

The AICPA urges the Subcommittee to include reimbursement of fees and costs of administrative appeals to the Internal Revenue Service in this legislation. Failure to do so will encourage taxpayers to bypass a possibly simple and productive method of resolving their problems in favor of litigation, simply because their costs may be recovered if they prevail. This greater use of the courts will naturally clog court dockets, will cost the taxpayer and the government additional money, and will delay resolution of contested issues. The complexity, delays, and uncertainty involved in litigation may put the taxpayer's business (and possibly the taxpayer) under unnecessary stress and will delay the payment of tax or receipt of a refund by the taxpayer.

We believe that fees and expenses should be covered from when the taxpayer receives a 30 day letter from the IRS. This letter notifies the taxpayer that he or she has 30 days to respond in writing to the proposed deficiencies asserted by the IRS. Prior to receipt of the 30 day letter, the IRS would be examining records and engaging in fact finding, and professional fees incurred to deal with this activity would not seem to be included in the spirit of the bills which have been introduced. The issuance of the 30-day letter signals the beginning of a controversy between the IRS and the taxpayer.

The AICPA also urges the Subcommittee to clearly include the fees of CPAs, as well as attorneys, in reimburseable fees and costs. CPAs represent taxpayers before the IRS and before the Tax Court. This area of practice serves the public well and is firmly established in the law, in the Tax Court's rules of practice, and in the Department of the Treasury's Circular 230 which regulates practice before the IRS.

CPAs routinely render services for tax advice, tax planning, tax return preparation and represent clients through all levels of the Internal Revenue Service administrative process. They have a continuing involvement with their clients' financial and tax matters. In many instances CPAs have prescribed the tax treatment which results in the contested issue. The CPA then, in most circumstances, would be the logical representative for the taxpayer to employ to handle the tax controversy at its initial stages, during the IRS agent's examination, and through the IRS appellate procedure. Although CPAs render assistance to attorneys during pre-trial conferences and actual tax litigation, the CPA is likely to have his or her greatest involvement representing the taxpayer before the Internal Revenue Service and to the point of trial. These fees can be very substantial and in many cases might be more substantial than attorney fees and expenses dealing with the actual trying of the case. In other words by the time the controversy reaches the court, substantial fees and expenses have already been incurred.

We believe that taxpayers should be free to choose from among professionals qualified to represent them before the IRS under Circular 230 which permits taxpayers to be represented by attorneys, CPAs, or enrolled agents, and to represent them before the Tax Court under the courts rules which permit attorneys and CPAs to qualify to practice.

To permit reimbursement of fees of attorneys only would place other tax practitioners at a competitive disadvantage in representing clients in disputes and might result in the unwarranted conclusion that attorneys are the only "approved" practitioners in such situations. This could also affect practitioners in other areas of tax practice by encouraging clients to use attorney services in case a dispute with the government should arise or simply because attorneys appear to be "approved."

Thank you for this opportunity to testify. I would be happy to respond to any questions you may have.

STATEMENT OF

JOHN S. NOLAN
CHAIRMAN, SECTION OF TAXATION

on behalf of the

AMERICAN BAR ASSOCIATION

before the

SUBCOMMITTEE ON OVERSIGHT
OF THE INTERNAL REVENUE SERVICE

of the

COMMITTEE ON FINANCE

of the

UNITED STATES
SENATE

concerning

PAYMENT OF ATTORNEYS' FEES IN TAX LITIGATION

OCTOBER 19, 1981

Mr. Chairman and members of the Subcommittee, I appreciate this opportunity to express the views of the American Bar Association on the important matter of attorney fee awards to taxpayers who prevail in civil tax litigation against the Government. My name is John S. Nolan and I am Chairman of the Association's Section of Taxation.

It is the position of the American Bar Association that the Tax Court, as well as the U.S. District Courts and Court of Claims, should be authorized to award reasonable attorney fees and expenses to a taxpayer who prevails in a civil tax proceeding. There are, however, some significant deficiencies in the Equal Access to Justice Act and in bills which have been introduced to provide for such awards in tax cases which should be rectified.

In the Equal Access to Justice Act, Congress has approved attorney fee awards against the Government on an experimental basis in many types of cases, including tax litigation. The provisions of the Act, which become effective for a three-year period beginning October 1, 1981, limit reimbursement to individuals having a net worth of $1,~~000,000~~ MIL or less, businesses and other organizations with a net worth of $5,~~000,000~~ MIL or less or having 500 or fewer employees, tax-exempt charitable organizations, and certain agricultural cooperatives. Where a party eligible for reimbursement under the Act prevails in litigation with the Government, he

is entitled to an award of attorney fees and other costs of the litigation unless the Government can demonstrate that its position was "substantially justified" or that "special circumstances would make an award unjust."

Although the draftsmen of the Equal Access to Justice Act clearly intended to bring tax cases within its scope (see S. Rep. 96-253, 96th Cong., 1st Sess. (1979), p. 3), a technical oversight may have excluded Tax Court proceedings (but not tax litigation in the District Courts and Court of Claims) from the provisions of the Act. The Act's authorization to award attorney fees against the Government is contained in section 2412 of Title 28 of the United States Code, which deals with U.S. Courts created under Article III of the Constitution, but the Tax Court was created under Article I of the Constitution (see section 7441, I.R.C. 1954) and is governed by provisions of the Internal Revenue Code that have not been expressly amended to authorize the Court to award attorneys fees.

We urge that prompt action be taken by Congress to clarify this situation by making clear that the Tax Court is authorized to award attorney fees in tax litigation under the same standards as are applicable in tax litigation in the District Court and Court of Claims. There is no justification for treating taxpayers differently in this regard depending upon the forum in which the tax dispute is heard. It would

be doubly unfortunate if the Tax Court were not covered, for it is the only forum in which taxpayers may litigate their tax disputes with the Internal Revenue Service without first having to pay the tax which the Service alleges to be due. The Tax Court is thus the forum of choice for the overwhelming majority of taxpayers, particularly small businesses and individuals of moderate means, and its exclusion would deny the benefits of the Act to the very class of persons Congress most wished to help.

We are aware of two bills introduced in the Senate and referred to the Committee on Finance that provide for reimbursement of attorney fees in Tax Court as well as other tax litigation proceedings. S. 752, introduced by Senator Baucus, would award attorney fees to prevailing taxpayers without any net worth test, but would place a cap of $20,000 on the amount of attorney fees and other expenses that could be recovered from the government and would require taxpayers to prove that the government's position was not only incorrect, but "unreasonable". S. 1673, introduced by Senator Grassley, would use the same standards as S. 752, except that it would place a cap of $25,000 instead of $20,000, on the amount of attorney fees and other expenses that could be recovered from the government.

While we recognize that limits on reimbursement of attorney fees may be necessary at this experimental stage, some restrictions are clearly more objectionable than others. In general, we think a maximum recovery amount, such as the $20,000 and $25,000 limitations in S. 752 and S. 1673, are preferable to a net worth test such as that contained in the Equal Access to Justice Act. Even a more affluent taxpayer may be forced to accept an artibrary IRS position when the costs of litigation, absent an attorney fee reimbursement provision, would exceed his recovery whether or not he is successful in court. Moreover, determining the net worth of an individual or an organization may embroil the court in controversies that are as difficult as the substantive tax issues it has just decided. Congress should avoid placing restrictions on the recovery of attorney fees that would significantly prolong tax controversies and divert judicial resources from an already overburdened tax litigation process.

For the same reason, we think it unwise to condition recovery of attorney fees on a showing by the taxpayer that the Government's position in the case was "unreasonable." A term so vague invites controversy, and leaves the court virtually without standards. For example, is it unreasonable for the Internal Revenue Service to adopt a policy of litigating every case involving a particular issue (as it did with family partnerships and professional service corporations a number of

years ago) until it obtains a result in accord with its interpretation of the Internal Revenue Code? Should a taxpayer bear the burden of litigation instigated or continued by the Government as a "test case" for the purpose of providing judicial guidance to the Internal Revenue Service in its administration of the tax laws for the benefit of all taxpayers?

The "substantially justified" standard of the Equal Access to Justice Act is equally vague, but at least places the burden of proof on the Government, which is in the best position to explain why it brought or defended the case. If the taxpayer is required to prove the "unreasonableness" of the Government's position, he will likely have to seek his proof from the Government's records of the process it followed in formulating its position. Such materials might be available, however, only through discovery, and the Government is likely to claim that a substantial portion of them are privileged This may well produce additional litigation involving discovery requests for internal memoranda, communications, and depositions of, or interrogatories to, Government personnel and Government resistance to production of documents or other discovery by private litigants through assertions of privilege.

Accordingly, if the Congress decides to retain a concept of "unreasonableness" or lack of "substantial justification" as a condition of fee awards in tax cases, the burden

of proof should be on the Government which, after all, has by definition lost its case against the taxpayer. Moreover, Congress should provide policy guidelines for the courts to apply, either in the statute or committee reports. For example, Congress might specify that the following situations would entitle a prevailing taxpayer to a fee award.

(1) The Government has previously lost a final decision on the legal issue in another forum and does not have a favorable decision in any other forum.

(2) A reasonable investigation of the facts would have demonstrated to the Government that it was unlikely to prevail.

(3) Existing law and precedent, even if not directly controlling, made it unlikely that the Government would prevail.

(4) The Government's position is contrary to a published administrative position or longstanding administrative practice.

(5) The facts and circumstances of the case demonstrate that the Government has attempted to use the costs of litigation to extract taxpayer concessions which were not justified by the facts of the case.

On the other hand, a fee award ordinarily would not be appropriate where the taxpayer's own failure to cooperate in a reasonable administrative investigation leaves the Internal Revenue Service with no choice but to litigate his tax liability. The Service would also be "substantially justified" in defending a Treasury regulation in court in most cases, even though the court ultimately decides that the regulation is invalid. Moreover, in general, the "substantially justified" standard should not be interpreted so rigidly as to discourage the Government from litigating reasonable legal positions merely because they are novel or controversial.

It must be acknowledged that taxpayers will be less likely to seek administrative settlements before going to court if attorney fees and other costs incurred in proceedings before the Internal Revenue Service are not reimbursable. Unless Congress intends to reimburse taxpayers for costs incurred in pursuing administrative appeals within the Internal Revenue Service, some method should be devised to insure that taxpayers make a good faith effort to utilize the Internal Revenue Service's appeals procedures before bringing their disputes to court. Neither the Equal Access to Justice Act nor the attorney fee bills pending before the Finance Committee address this issue, however.

Taxpayers might be required to exhaust their administrative remedies in the Service as a condition to receiving attorney fee awards. Taxpayers who do not make good faith efforts to have proposed deficiencies reversed or reduced in the Revenue Service's Appeals Office should be allowed to proceed in court if they wish, as under present law, but they should not be permitted to recover attorney fees from the Government in such cases unless the court finds that it would have been futile for the taxpayer to pursue his administrative remedies under the circumstances of the particular case.

The Internal Revenue Service should also be encouraged to take the initiative in proposing settlements in appropriate cases. A taxpayer could be denied recovery of his attorney fees upon a showing that he had refused an offer of settlement from the Internal Revenue Service on terms no less favorable to the taxpayer than the terms of the court's ultimate judgment unless the taxpayer could show that the case involved a continuing issue which the Service had refused to concede for future years. This approach is analogous to the rule governing assessment of costs in Federal District Courts under Rule 68 of the Federal Rules of Civil Procedure.

Finally, the term "prevailing party" as used in the Equal Access to Justice Act may give rise to problems of interpretation in the special circumstances of tax litigation.

Tax cases frequently involve more than one issue, and the most significant issue is not necessarily the one involving the most tax dollars. For example, so called "timing" issues (whether an item is deductible in one year rather than another) are likely to be less important to a taxpayer than an issue as to whether an item is taxable at all, even though the timing issue may appear to involve more money. S. 752 and S. 1673 would make this distinction clear in tax cases by defining a prevailing party as one who has either substantially prevailed with respect to the amount in controversy or has prevailed with respect to the most significant issue or set of issues presented. However, even without such a standard in the Equal Access to Justice Act, we suspect that courts will probably reach the same result.

In summary, while the American Bar Association believes that it is reasonable to award attorney fees and expanses to prevailing taxpayers in civil tax litigation with the Government, it is imperative that the authority to make such awards be unequivocally extended to the Tax Court where the average taxpayer typically brings his tax case. We believe that in general it is unwise to impose conditions on awarding attorney fees beyond the requirement that the taxpayer prevail in his case, although an exhaustion of the administrative remedies requirement may be necessary to encourage settlements

and avoid unnecessary litigation. In all events, any requirements in addition to the prevailing party standard should be easily applied by the courts so as not to protract the litigation and further burden the tax litigation system.

Mr. Chairman, we appreciate the opportunity of participating in these hearings and trust that if we can be helpful in further consideration of this important matter you will feel free to call upon us. Certainly we stand ready to work with you and the Subcommittee staff and look forward to doing so.

STATEMENT OF

JAMES D. "MIKE" McKEVITT
Director of Federal Legislation

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Before: Subcommittee on Oversight of the Internal Revenue Service, Senate Committee on Finance

Subject: Legislative Proposals Relating to Payment of Court Costs and Other Fees in Tax Litigation

Date: October 19, 1981

Mr. Chairman, NFIB on behalf of over 500,000 small and independent business members appreciates the opportunity to comment on S.752 and S.1673 providing for the awarding of reasonable court costs and certain fees to prevailing parties in civil tax actions.

We congratulate the Subcommittee for "going the final mile" by attempting to provide a prevailing taxpayer suitable recompense for fees incurred in the successful defense of a government action in the Tax Court. Reimbursement of court costs and attorney's fees was one of the top fifteen recommendations of the last White House Conference on Small Business.1/ Moreover, NFIB members supported this proposal by a large Mandate margin, 85 percent to 11 percent.

As you are aware, NFIB vigorously endorsed and worked for the enactment of the 1980 Equal Access to Justice Act (P.L.96-481). Unfortunately, Congress at the time of this Act's

passage delayed the effective date of the Act to provide time for the Committees with jurisdiction over tax matters to enact a separate bill governing fees in Tax Court cases. It is this deficiency which the NFIB respectfully requests that this Congress rectify at the earliest possible time.

NFIB strongly believes that the Tax Court, as well as the U.S. District Courts and Court of Claims, should be authorized to award reasonable fees for IRS-approved practitioners (as defined in IRS Circular 230) as well as expenses for a taxpayer who prevails in a civil tax proceeding. This proposal would treat the Tax Court by the same standards as the District Court and Court of Claims for purposes of awarding practitioner fees in tax litigation.

NFIB feels that there is no reasonable justification for treating taxpayers differently depending upon the forum in which the tax dispute is heard. This is especially true since the Tax Court is the only forum in which taxpayers may litigate their tax disputes with the Internal Revenue Service without first having to pay the tax which the Service alleges to be due. Because the taxpayer must pay and sue for a refund in the other available forums, the Tax Court is the only forum for a taxpayer with illiquid or limited resources. For NFIB businesses burdened by inflation, high interest rates and the attendant financial leverage problems, the Tax Court is the only viable forum for conflict resolution of this nature. Moreover, the prime motivation in creating the Tax Court was to provide a forum for taxpayers to litigate the determination of their tax liability prior to payment.2/ Denying taxpayers the ability to

recover their practitioner and other fees in Tax Court is a detriment impacting specifically upon the class of taxpayers that Equal Access Legislation was designed to help.

Focusing on two Bills already introduced in the Senate, S.752 and S.1673, which specifically address this inequity, it is our feeling that neither Bill adequately covers our concerns in this area.

First, the Bills being considered by the Committee would provide for an award of fees whenever the taxpayer plaintiff "substantially prevails" and the Government position was "unreasonable." NFIB strongly supports legislative language that shifts the burden of proof to the Government, the party in the most cost-effective position of assuming this burden. We further feel that it is imprudent to condition a recovery of fees based solely on a nebulous Government standard of 'unreasonableness'. Awarding courts or administrative tribunals should be allowed fairly broad discretion to award fees by taking into account equitable considerations such as the relative resources and economic strength of the taxpayer. Any lesser burden of proof or fee awarding criteria would negate the very intent of legislation of this kind, which is to ensure that the vast enforcement power of the Federal Government be selectively and prudently exercised.

Under either burden of proof or standard for recovery, a cogent argument can be advanced that the proposed legislative changes would result in a quantum jump in fee awards at a time of severe budgetary constraint. However, NFIB feels that

appropriate checks can be added to the legislation which would function as an effective antidote. For one thing, NFIB endorses a requirement that the taxpayer exhaust the administrative process prior to docketing a case in court. Since justice delayed is indeed not only justice denied but also a tremendous investment of resources for a small business, we do not wish to discourage an expeditious settlement of cases. Failing to explicitly provide for this procedure will only encourage some taxpayers to bypass a possibly simple and productive method of resolving their problems in favor of litigation, simply because their costs may be recovered if they prevail in Tax Court. By mandating the reimbursement of fees and costs of administrative appeals to prevailing taxpayers by the IRS after it has been determined that the administrative appeals process has been exhausted, Congress could preclude the possible inundation of Tax Court dockets and avoid the resulting time-consuming and expensive delay in resolving tax controversies which our membership can ill afford.

As a future counterbalance to the possibility of "opening the floodgates of litigation" NFIB would support any concomitant increase in the damages meted out against taxpayers who institute court proceedings merely for delay or for other unjustified purposes. To this end, since Code Section 6673 presently authorizes the Tax Court to enter damages of up to $500 against taxpayers who institute frivolous proceedings, we would urge that the maximum amount of such damages under this provision be increased significantly.

When these changes are factored in with so-called "small case" procedures under Code Section 7463, NFIB feels that effective procedural ballast has been created to mitigate the potential flood of tax litigation induced by fee awards and broader standards of proof.

A final refinement of the two Bills under scrutiny concerns the ceiling on the amount of fees and other expenses that could be recovered from the Government. NFIB does not support any cap on amounts recoverable. What we as a representative of small business seek to attain by this legislation is an identifiable shift from one-sided "fear and trembling" on the part of our nation's taxpayers to a more acceptable "balance of terror." There is evidence that small firms frequently do have reason to believe that the government has brought unjust or inflated civil charges against them. For example, the Chief Judge of the United States Tax Court reported that in 1975 the IRS won less than one of every three dollars it charged taxpayers with underpaying.

"In the total number of cases for last year, the amount of deficiencies determined by the IRS was $490,806,178. The amount redetermined by the Tax Court was $145,324,630. That figure comes out to a percentage recovered by the government of 29.6 percent."3/ (See Table)

Concern that awarding litigation costs with no cap will subject the Government to substantial, indeterminate liabilities is not so much an excuse to support the status quo as it is an effective warning that the Federal Government judiciously allocate their vast and often times overwhelming resources to areas of the greatest need. The aforementioned statistics as well as the

comments of our membership perhaps indicate a need for change. In our experience, small businesses have one overriding concern when embroiled in tax controversies, i.e., to vindicate themselves at the lowest possible cost in time, resources and energy. Any fear of practitioner abuses such as "churning" cases or deliberately delaying resolution of cases can be squelched by appropriate penalties and, even more significantly, by the formulation by the IRS of a comprehensive and comprehensible description of the taxpayers rights and the avenues at his/her disposal to protect them.

We have attempted to offer constructive suggestions as to how to best provide for small business access to the judicial process and restraint of unwarranted government action on the one hand versus timely judicial resolution of pending controversies and proper enforcement of tax laws on the other. While other interests may decry the chilling effect on the enforcement of the Internal Revenue Laws, we at NFIB bear witness every day to the equally chilling effect on productivity and ultimately on lost tax revenues of federal regulatory overkill of small business.

NFIB welcomes any comments which this Subcommittee may have with respect to our statement and stands ready to provide you with any pertinent information at our disposal.

Table 1

Analysis of Tax Court Redeterminations

Method of Closing	No. of Dockets	Amount of Deficiency Determined by IRS	Amount of Deficiency Redetermined by Tax Court	Percentage Recovered by the Government
		Small Tax Cases		
Stipulation	1,993	$ 1,147,930	$ 528,840	46.1
Opinion	304	189,130	146,690	77.5
Total	2,297	$ 1,337,060	$ 675,530	50.5
		Regular Cases		
Stipulation	4,405	$429,474,600	$119,015,700	27.7
Opinion	655	59,994,510	25,633,400	42.7
Total	5,060	$489,469,110	$144,649,100	29.6
		Total Cases		
Stipulation	6,398	$430,622,530	$119,544,540	27.8
Opinion	959	60,183,640	25,779,990	42.8
Total	7,357	$490,806,170	$145,324,530	29.6

Note: Data excludes cases dismissed without determination by the Court

Senator GRASSLEY. Thank you, Mike, John, and Timothy, for your contributions to this debate on this issue.

I now call to the witness table David Keating, director of legislative policy, National Taxpayers Union, Washington, D.C., and Thomas J. Donohue, president of the Citizens Choice, Washington, D.C.

Would you like to start, David?

Mr. KEATING. Yes.

STATEMENT OF DAVID KEATING, DIRECTOR OF LEGISLATIVE POLICY, NATIONAL TAXPAYERS UNION, WASHINGTON, D.C.

Mr. KEATING. Thank you, Mr. Chairman, for the opportunity to express the views of the National Taxpayers Union on legislation relating to payment of attorney's fees in tax litigation.

I have a prepared statement to submit for the record.

[The prepared statement follows:]

STATEMENT OF DAVID KEATING
DIRECTOR OF LEGISLATIVE POLICY,
NATIONAL TAXPAYERS UNION
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE
COMMITTEE ON FINANCE
UNITED STATES SENATE
OCTOBER 19, 1981

Summary of Principal Points

* The National Taxpayers Union supports the concept of reimbursement of costs for taxpayers who prevail in tax litigation.

* Under current law, it is often cheaper for taxpayers to pay than to battle unfounded IRS claims.

* NTU recommends:
  - Giving the Tax Court explicit authority to award payment of fees to the prevailing taxpayers.
  - Making fee awards mandatory to the prevailing taxpayer.
  - Authorizing fee awards at the administrative level.

* NTU opposes:
  - Requiring that the taxpayer prove the position of the Government was unreasonable.
  - Making the Government eligible for fee awards.
  - Limiting reimbursement of fees other than to a reasonable amount.

Mr. Chairman and distinguished members of the Committee, on behalf of the 450,000 family members of the National Taxpayers Union in all 50 states, thank you for the opportunity to express our views on legislation relating to payment of attorneys' fees in tax litigation. We favor the concept of reimbursement of costs for taxpayers who prevail in tax litigation and support enhancing the Equal Access to Justice Act as it applies to tax cases.

The Problem: It's Cheaper to Pay Than to Battle Injustice

Currently, the taxpayer faces extreme disadvantages when a dispute arises with the Internal Revenue Service (IRS). Compared to the individual taxpayer, the IRS has virtually unlimited resources. If the taxpayer loses the dispute, he loses time, wages, expenses, and can be assessed penalties. If he wins, he gets to keep his money minus court costs, time, wages and other expenses incurred. These costs frequently exceed the amount of money the taxpayer is allowed to keep. The result is frustration as taxpayers decide it's cheaper to pay than to battle injustice. This creates an incentive for the IRS to make unfounded claims, knowing that it is often cheaper for the taxpayer to pay than to defend himself.

To correct this injustice, taxpayers who prevail in legal disputes with the IRS should be reimbursed for their full legal costs. These costs should include attorney fees, accounting fees, and the costs of any analysis or study, as well as any direct court costs. By providing for reimbursement of such costs, taxpayers would not be deprived of a real opportunity to defend themselves, and taxpayers would be protected from frivolous IRS claims.

We were heartened by passage of the Equal Access to Justice Act during the 96th Congress. The Equal Access to Justice Act will help reduce the awesome disadvantages taxpayers now face in a dispute with the IRS.

Equal Access to Justice Act Needs Clarification for Tax Cases

There are several steps that should be taken to enhance the Equal Access to Justice Act as it applies to tax litigation. The most important is to give the Tax Court explicit authority to award payment of fees to taxpayers who prevail in tax litigation.

We also believe that awards of fees should be mandatory except in narrowly defined circumstances, certainly no broader than those provided for in the Equal Access to Justice Act. Unfortunately, we fear that if it is left to the discretion of the Tax Court, taxpayers may not get the relief they deserve.

A formula approach may be worth placing in legislation. To determine the percentage of fees that should be awarded, one could weigh the claim made by the IRS versus the deficiency assessment, if any, left once the case has been resolved by the Tax Court. For example, if there was a $10,000 claim by the IRS, but after litigation only a $1,000 assessment remained, the taxpayer could be said to have won 90% of the case, and would therefore be reimbursed for 90% of fees. Such a provision would actually encourage less litigation because it would encourage the IRS not to litigate frivolous claims.

Some commentators have warned that awards of fees may encourage litigation by taxpayers who would circumvent administrative remedies. The best remedy would be to authorize reimbursement of fees and costs incurred during administrative appeals to the IRS. After all, costs incurred at the administrative level can be substantial and can easily exceed the claim made by the IRS. If a large cost barrier remains at the administrative level, the typical taxpayer will still not be able to afford assistance. Another solution, although not as desirable, would be to specify that taxpayers should exhaust administrative remedies in order to qualify for fee awards in tax court. Fee awards should cover all reasonable expenses incurred following receipt of the 30 day letter from the IRS.

It has been argued that the Government should also be eligible for fee awards. We strongly oppose this proposal for several reasons. Let's not forget that when the Government prevails, it collects money from the deficiency assessment. It may also collect penalties and interest. When the taxpayer prevails, he collects nothing. He has simply proved that he is right and that no additional tax is owed. It is also important to remember that much of the burden of proof rests with the taxpayer if he is to prevail in this type of litigation.

The taxpayer also bears the burden of calculating his taxes, keeping records, and hiring reliable advice. Finally, due to the withholding system, most taxpayers effectively give the Government an interest free loan over the course of the year.

If such a provision were added to a bill that also required that the taxpayer prove that the Government acted unreasonably before collecting fee awards, then the taxpayer would be better off under current law.

We commend the Chairman and the sponsors of S. 1673 for introducing legislation on this important issue. Although we feel the bill offers some relief to taxpayers, we do not believe S. 1673 will effectively solve the

problem because it leaves relief to the discretion of the court and requires that the taxpayer prove that the position of the United States was unreasonable. It's hard to see how the taxpayer could possibly prove that the government was unreasonable. The government has the facts in its control as to why it pursued its action. At the very least, the burden should be on the IRS to prove that it was not unreasonable. If the taxpayer wins the case we feel he should be reimbursed for reasonable court costs. If the position of the IRS and the United States is wrong, taxpayers should not have to further prove that the position is unreasonable and then rely on the discretion of the court to reimburse court costs.

S. 1673 limits reimbursement of court costs to $25,000. The bill already limits reimbursement of court costs to a reasonable amount. If the costs are reasonable, and over $25,000, there is no fair reason not to reimburse the taxpayer. This provision guarantees that the IRS regains the inherent advantages over the taxpayer in a case of above average complexity.

In summary, we hope that the Committee will move to enhance the Equal Access to Justice Act as it applies to tax litigation.

Mr. KEATING. I am David Keating, director of legislative policy of the National Taxpayers Union.

We favor the concept of reimbursement of costs for taxpayers who prevail in tax litigation and support enhancing the Equal Access to Justice Act as it applies to tax cases. We commend you and the other members of the committee for introducing legislation on this subject and for holding hearings today.

I think the problem is well known. I won't go into the details here. Basically, it is often cheaper for the taxpayer to pay an IRS claim than to battle for justice. That's why we were heartened by passage of the Equal Access to Justice Act during the 96th Congress. The Equal Access to Justice Act will help reduce the awesome disadvantages the taxpayers now face in a dispute with the IRS.

There are basically two steps that we feel should be taken to enhance the Equal Access to Justice Act as it applies to tax cases. The most important is to give the Tax Court explicit authority to award payment of fees to taxpayers who prevail in tax litigation.

We also believe that awards of fees should be mandatory except in narrowly defined circumstances, certainly no broader than those provided for in the Equal Access to Justice Act. We fear that if it is left to the discretion of the court, taxpayers may not get the relief they deserve.

Some commentators have warned that awards of fees may encourage litigation by taxpayers who would circumvent administrative remedies. We feel the best remedy would be to authorize reimbursement of fees and costs incurred during administrative appeal levels to the IRS. After all, for small taxpayers, costs incurred at the administrative level can be substantial and easily exceed the claim made by the IRS. Thus, the same problem remains. It's cheaper to pay than to battle through the administrative level.

If a large cost barrier remains at the administrative level, the typical taxpayer will still not be able to afford assistance. Another solution would be to specify that taxpayers should exhaust administrative remedies in order to qualify for fee awards in the Tax Court. If this solution is chosen, we would agree with the Certified Public Accountant's Association that fee awards should cover all reasonable expenses incurred following receipt of a 30-day letter from the IRS.

I would also like to express our strong opposition to any requirement that the taxpayer prove that the position of the United States was unreasonable or that it acted in so-called bad faith.

We think it is hard to see how the taxpayer could possibly prove that the Government was unreasonable or acted in bad faith. The Government has in its control the facts as to why it pursued these actions. At the very least, we feel the burden should be on the IRS to prove that it was not unreasonable.

I would like to make one quick comment on one of the other amendments that you are contemplating. We would also favor granting awards at the small claims level as well.

In summary, then, we hope that the committee will move to enhance the Equal Access to Justice Act as it applies to tax litigation. We offer our assistance to you and the subcommittee staff as you consider this legislation.

Thank you.

Senator GRASSLEY. Tom.

STATEMENT OF THOMAS J. DONOHUE, PRESIDENT, CITIZEN'S CHOICE, WASHINGTON, D.C.

Mr. DONOHUE. Senator, it is nice to be back to stay on a subject that both of us are interested in.

[The prepared statement follows:]

PREPARED STATEMENT OF THOMAS J. DONOHUE, PRESIDENT, CITIZEN'S CHOICE, INC.

Mr. Chairman and Members of the Committee:

I am Thomas J. Donohue, President of Citizen's Choice, a national grassroots taxpayers' organization founded in 1977. Citizen's Choice presently has over 75,000 members nationwide representing all sectors of our society.

I am pleased to have this opportunity to testify before the Senate Subcommittee on Oversight of the IRS on the topic of reimbursing taxpayers who prevail in tax litigation for reasonable expenses incurred in such litigation. Citizen's Choice is particularly interested in this subject based on the results of a recently-concluded investigation by the Citizen's Choice National Commission on Taxes and the IRS into the relationship between taxpayers and the government. As a result of this study, the Commission made a number of recommendations to Congress, and Citizen's Choice has had the privilege of presenting several of these recommendations in testimony before various Committees of the House and Senate. One recommendation to Congress that came out of this study was that taxpayers who succeed in contesting a tax dispute be reimbursed for attorneys' fees and court costs.

Citizen's Choice established its National Commission on Taxes and the IRS in October of 1979 in response to its members' complaints about tax administration. The Commission was made up of 25 prominent business, academic and professional

leaders and was chaired by David McCarthy, Dean and Executive Vice President of the Georgetown University Law Center. The primary aim of the Commission was to explore taxpayer attitudes towards the IRS and its tax administration practices.

To carry out its exhaustive investigation, the Commission solicited the views of over 3,000 taxpayers by holding public hearings around the country, establishing a toll-free "Taxline" and by sifting through hundreds of letters, court documents and transcripts. Over the course of 16 months, members of this Commission and the Citizen's Choice staff held public hearings in ten metropolitan regions across the nation. Thousands of citizens attended these hearings and, along with the staff and commissioners, heard testimony from citizens representing all sectors of our society.

Frankly, the depth of concern, the magnitude of frustration and the level of anger and alienation which we found surprised all of us. It became quickly apparent that the state of citizen-government relations is not well. The American taxpayer is feeling increasingly alienated and frustrated by the pressures of an ever-increasing tax burden and a tax system which he cannot understand and therefore perceives to be both unfair and frightening. Today's taxpayer feels he has few if any rights in our present tax collection system and an increasing number of otherwise law abiding citizens are beginning to fight back through various tax avoidance gimmicks.

The most disturbing thing we learned was that fear is a deep and pervasive element of taxpayer attitudes towards the tax system and the IRS in particular. A common analogy was made between the taxpayer and the criminal, pointing out that a large, well known body of rights exists for a person accused of a crime, although no similar set of "rights" or guidelines exists for the taxpayer. We found that most taxpayers believe that criminals have a much clearer understanding of their rights under the 1966 "Miranda" warning than taxpayers have in dealing with the Internal Revenue Service.

The Commission found that this fear causes many taxpayers to deliberately pay more tax than they legally owed simply to avoid a traumatic encounter with the IRS. It appeared from the testimony that many IRS agents regard fear and intimidation as legitimate investigative tools. Many taxpayers reported their perception that the IRS acts on a "presumption of guilt" -- that an agent regards a taxpayer as guilty of evasion until proved innocent.

A tax attorney with an extensive practice before the IRS put it this way when he testified at our hearing in Tampa:

> "Essentially our first contact with the Service is: This person owes the taxes and should pay with whatever they have at the time, or this person has attempted to evade taxes or unlawfully failed to file a tax return. And

immediately the burden is shifted to the taxpayer to prove otherwise. And that's a principle that is followed and practiced."

The notion that auditing agents proceed on a presumption of guilt was reflected in the testimony of many witnesses, including a member of Congress and a former IRS agent.

Other suspicions among taxpayers, CPA's and tax attorneys which add to this widespread "fear factor" include a common belief that IRS agents have a monthly or annual quota system. Many also believe that the IRS has sets of secret rules with which to decide particular kinds of cases -- rules to which the public is not privy.

As I've mentioned, there are a large number of taxpayers who are so intimidated by their tax system that they in effect purchase their civil rights -- and their peace of mind -- by paying taxes in excess of what they actually believe they owe, "just to be safe." And, although the United States has one of the highest compliance rates in the world, many citizens are beginning to take the opposite tack. Spurred in part by a perception that the tax system is fundamentally unfair, that tax avoidance is rampant (in other sectors of society) and that the chances of being audited are slim, these taxpayers are joining the so-called "underground economy," or evading taxes in some other manner. The IRS estimate of some $26 billion in lost revenue this year illustrates the magnitude of this problem.

It has become obvious to Citizen's Choice that Congress must act quickly to reassure the taxpayers of their rights and institute long overdue reforms in the tax system if the federal government hopes to regain the confidence and respect of its citizens and taxpayers. We are greatly encouraged to see Congress responding in a timely fashion.

The problems I have described are only symptoms of the real problem, an unmanageable tax code. The only lasting solution to this problem is a sweeping revision of the tax laws to produce a simpler, fairer and more efficient revenue system. Citizen's Choice realizes that this is a long-term solution that will require years of work. However, the frustration felt by taxpayers can be ameliorated to a great extent by more immediate measures.

The Citizen's Choice National Commission on Taxes and the IRS has made a number of specific recommendations both to the Congress and the IRS to ease the present adversary character of taxpayer-government relations. One step which the Congress has already approved is to halt unlegislated tax increases by indexing the income tax schedule. Another step currently under consideration in both chambers of Congress is the enactment of a "Taxpayer Bill of Rights" to make citizens aware of their rights in the tax administration process.

Today we are discussing another necessary part of this tax reform pattern. The enactment of separate legislation to provide for the full reimbursement of costs to those taxpayers who prevail in tax litigation would go a long way toward easing the tension between taxpayer and government. The Equal Access to Justice Act, Public Law 96-481, provides a good model for this legislation, but it was not designed to cover the special characteristics of tax litigation. The writers of PL 96-481 recognized this when they delayed the effective date of that law to October 1, 1981 to allow the taxwriting committees to write a parallel measure for application to tax litigation.

Citizen's Choice urges you to act swiftly in passing such a measure. At the present time many taxpayers, intimidated by the power of the IRS, find it not only easier but much cheaper to concede a dispute and pay. It is the rare taxpayer who wishes to incur the time consuming legal and mental anguish to contest the IRS. Our present system discriminates unfairly against those individuals and small businesses which do not have adequate means to hire the attorneys and accountants necessary to face the IRS in court. Such a measure as we are recommending would put all taxpayers on a more equal footing in our tax administration process. Providing taxpayer reimbursement would also restrain the IRS from indiscriminantly challenging taxpayers in court.

This legislation should be seen, both by legislators and administrators as only part of a larger pattern of tax reform. It should be designed to work together with other measures such as a "Taxpayer Bill of Rights" to educate citizens about their rights and to help them deal effectively with the IRS. We do not believe that this measure will encourage citizens to bypass administrative remedies in favor of litigation if they are fully informed of their rights in the revenue collection process. However, when litigation is a last resort, citizens should not be deterred by lack of financial resources.

It is the responsibility of Congress to guarantee that taxpayer is treated with respect and with the full measure of protection under the law that they are due as American citizens. We therefore urge the members of this Subcommittee to expedite the passage of a bill similar to the Equal Access to Justice Act to provide for taxpayer reimbursement.

On behalf of the members and staff of Citizen's Choice, I offer to this Subcommittee and to any of its members in particular, our assistance in any way you might find it helpful toward reaching our common goal of a more effective tax administration system.

We look forward to working with you to this end.

Mr. DONOHUE. As you know, as president of Citizen's Choice, I represent almost 80,000 individual citizens who contribute their efforts and their resources to fund the National Commission on Taxes in the Internal Revenue Service, which conducted an 18 month study of this very subject and these problems.

Following our study, which was concluded about half a year ago, we submitted to the Treasury and to the Internal Revenue Service a series of reasonable and specific recommendations which had been discussed with this committee and other committees of the Congress. And these recommendations, I must point out, have been received with favor and interest but absolutely no action has taken place. And one of the reasons that we have had no action can be seen with the testimony we had this morning with the Director of the Internal Revenue Service and with the Assistant Secretary of Treasury. And that is, everybody wants to talk about this; everybody wants to put all sorts of restraints and constraints and tell everybody about all their serious problems in trying to collect taxes.

But what our study found what is the reason behind, I believe, a lot of what you are doing, Senator, is that many small business people, many individual citizens, who don't have the resources to challenge that large bureaucratic agency are denied equal access to justice. And as one goes through the total process offered by the Internal Revenue Service—an expensive process if you are represented in anyway—one finds the longer you stay, the more expensive it gets. And unless you have significant resources to defend your case, it is unlikely that you are going to be able to persevere longer than a well-financed Government machine.

So I think what we have here today—and it has been said very well by many of the witnesses before, and I have submitted some testimony for the record—is a continuation of the theory offered by the IRS that if you maintain a certain level of fear in the taxpayer, you will get more people to pay their taxes. And it's time to give the individual citizen and the small businessmen in this country an opportunity to speak their piece as guaranteed by the Constitution.

I would make three very specific comments, or four, and then conclude my testimony.

First, I think the Government and the Congress and the Senate, in particular, has been very aggressive in moving forward on the two primary factors—or one of the primary factors at least that we found in our study that was hurting people. And this is the tax system that ran willy-nilly and just kept getting bigger and bigger and bigger because of inflation. And the question of indexing is going to take away some of the frustration, and some of the fear.

Now we are also getting at a major tax cut that the Senate lead the way on which will put some semblance of balance between those who make income and those that have to pay large amounts of taxes.

The third issue is the one now to address. And that's the collection system. And I think it is absolutely essential that we recognize that the rhetoric is piling up in this hearing room and in hearing rooms around the Congress. That people are writing about it and people are talking about it, but there is nobody, except perhaps you, Senator, who is standing up, and one or two of your colleagues

to really push this issue. And there are 9 or 10 taxpayer bill of rights around, but somebody had better get the weight around them on just two or three critical issues.

No. 1, the question of reasonable. If you ever get your own family and try and sit down with a few of your children and try and decide what is reasonable or not, you know that in using that word, nobody is ever going to collect from the Government. In my judgment, if you go to a Tax Court and you win, they lose. And that's basically the case in other litigation. If you go to court, you take your risks. If you lose, you collect; you can be forced to pay attorney fees to the other side. And I think we have to look at this in a reasonable way.

The other question is—one of them that I think is important and the final one I will comment on—exhausting all of the administrative opportunities available to you is very, very important. I agree with you. But you have got to recognize, as one of the gentleman said before, that if you go through that whole process, you are going to spend a lot of money. And if you go the whole way, and you go to court and you win, then you should be able to go back and collect in that direction.

The IRS is an essential agency of Government. We need the money to run it. But they have got to run it in such a way that the citizens can stand up and have a fair hearing.

Thank you very much, Mr. Chairman.

Senator GRASSLEY. First of all, Mr. Donohue, how do you believe that the current law on the recovery of attorney fees in tax cases, and specifically this legislation, will impact taxpayers' attitudes toward the IRS in the self-assessment collection system?

Mr. DONOHUE. Well, as I have said, Senator, what we found out in our study and what we have found since the study has been released is that the mentality of fear has lead in this country to two major actions by taxpayers. One is to pay more than they should pay. If there is anything in question, to pay more.

And another, which is something that we are all focusing on, is not to pay at all or to fund some way illegally not to pay. And we can look at the underground economy but we are only looking at the small portion of it as an explosive element in our economy. And I will tell you that small businessmen in this country and individual entrepreneurs and courageous citizens—if they thought that they could go into court and win, and if they won be reimbursed for their risks, there would be a lot of folks that would say, wait a minute. I am not going to roll over on this one. I am not going to pay more than I should. And I am not going to avoid income taxes. I am going to challenge the law or challenge the rule of the regulation, and I am going to go forward with it.

I think that is what entrepreneurs and individual citizens in every element of our society have looked for whether it is business or Government or academia or wherever it is—a chance to have a fair hearing. We built our Nation around that. I think that is why the Congress thought on the equal access to justice rule to move ahead in other areas. But they eliminated the tax code. Why? Are they afraid to go to court on their own rules and regulations? I think maybe.

Senator GRASSLEY. Mr. Keating, why do you favor the burden of proof being on the government to prove its position was reasonable?

Mr. KEATING. Well, I think it is basically because if you require that the taxpayer prove the government was unreasonable, that is a very difficult standard to prove. It would require a process of discovery—getting certain documents that the IRS may very well not want to release. There may be other problems in other sections of the law with releasing such documents.

I just think that if we go forward with a standard that the taxpayer prove the Government was unreasonable, it will basically take away any rights granted by this legislation. If we are to retain some sort of standard that a burden of proof be retained, I feel the logical place to put it would be to put it on the Government to show to the Tax Court that they were being reasonable. I think that would be difficult for them to prove because they have lost their case. If the Government has lost the case, it would be harder, I think, to prove that it was reasonable.

But, if we are to retain some standard, I would say let's shift it around. Most of the other burdens of proof are on the taxpayer when litigating a case with the IRS. And to also require that the taxpayer prove the Government was unreasonable, I think, would make the chances for a recovery of fees very remote.

Senator GRASSLEY. Is it your position, Mr. Keating, that regardless of the legislative standard, the award of attorney's fees and other costs to the prevailing party should be mandatory?

Mr. KEATING. I think it should be mandatory. One of the things that lead me to this conclusion was looking at Senator Allen's original amendment back in 1976. Now I understand there were some drafting flaws with the amendment, but certainly the intent of the legislation was to grant taxpayers attorney's fees when they prevailed. And the Tax Court did not look at it that way, to my understanding.

I think, therefore, that it should be mandatory except under narrowly defined circumstances. I think the best standard to use would be the same one that is used in the Equal Access to Justice Act where fees are awarded unless it can be shown that it would be unjust to award attorney's fees in that particular case.

Senator GRASSLEY. Do either one of you have anything you want to add?

Mr. DONOHUE. May I offer one political statement? You have had on your panels this afternoon, Senator, between Dave and myself and Mike McKevitt and others, folks that represent tens of thousands of individual citizens and small businessmen. If we can get this bill in the type of form that we can easily describe it, and move forward just another step or so, we can put a little bit of interest behind this on a national basis, I think, unless many of the taxpayer bill of rights or other pieces of legislation that have floated throughout these halls for the last 10 years. I think this will run. And all we need to do is go the next step forward. I think we would be very successful between Dave and myself and Mike and others in bringing some national attention to it. And I think that you would find a grateful taxpaying community.

It is not that tens of thousands of people are going to recoup their court costs. That is not the issue. The issue is that the opportunity is there to compete on a fair and equitable basis with a Government that has had it pretty much their way for a long period of time as you well know.

Senator GRASSLEY. Well, obviously, Senator Baucus and I are serious about proceeding in the direction we are or we wouldn't have had the hearing.

Mr. DONOHUE. That's exactly right.

Senator GRASSLEY. Thank you very much for your time, David and Tom

Mr. KEATING. Thank you, Mr. Chairman.

Mr. DONOHUE. Thank you.

Senator GRASSLEY. The last panel consists of Edwin I. Davis, certified public accountant, Houston, Tex.; Mr. Marc S. Orlogsky, director of the Hofstra University Law School Tax Clinic, Hempstead, N.Y.

Is Mr. Orlogsky here?

[No response.]

Senator GRASSLEY. He may not be here so we will proceed without him, Mr. Davis. I would appreciate it very much if you go ahead with your testimony.

Mr. KEATING.

Mr. DAVIS. OK, thank you, Mr. Chairman.

STATEMENT OF EDWIN I. DAVIS, CERTIFIED PUBLIC ACCOUNTANT, HOUSTON, TEX.

Mr. DAVIS. Mr. Chairman, I'd like to express my appreciation to you and this distinguished subcommittee for the opportunity to appear here in behalf of what I, and a lot of my clients, consider to be a highly essential piece of legislation enacted to mainly restore the confidence of the taxpayer in the street in the self-assessment system of the government.

I do not appear on behalf of any professional organization or special interest group. I merely appear on behalf of myself as a practicing certified public accountant. I am representing myself and my clients.

I was a former Internal Revenue agent—a field examiner. I have been in accounting and tax practice on my own account in the city of Houston for approximately 30 years. I do think I know a little bit about both sides of the fence between the Government's Internal Revenue Service and the taxpayer.

I would be the first to admit that there are honest differences of opinion. I would like to point out that there are a lot of fine charactered Revenue people that try to do a good job and call the shots right down the middle. I think they are to be commended. Unfortunately, I don't think they are encouraged enough to make themselves an example to their other fellow employees who are not necessarily so inclined.

On the other hand, we do know of instances where for reasons, which vary from almost both ends of the pole—there are situations in which the Government, through bad supervision and bad training or whatever takes positions that are unjustified. And they treat the taxpayer badly; they form a bad impression on him. And he

goes away feeling he has not had a fair shake; that he has been abused and been treated very arbitrarily. And I think that is what this subcommittee and the other committees of Congress need to address. And I think because of the high tax rates, and the unrest that exists among the taxpayers of those things—the way they get treated sometimes, I think something needs to be done to restore their confidence in the self-assessment system.

On the other hand, I don't advocate the abridgment of any of the Government's legal and justifiable rights to levy, assess, and collect a tax. They have the right to do that. I don't believe in abridging that right. A lot of people do. But I don't believe in it.

We have had the question of administrative costs this afternoon—which I will have more to say about later—about when they should start. Now the Government does have the right to come out and examine your books. They have the right to request and receive information under various provisions of the code, which is right. Up to a point, at least until you get the Internal Revenue agent's report, you don't have a controversy locked in with them. So I disagree with a lot of people that have testified on various panels with me before, that they think when the phone rings, the meter should start running. I disagree with that entirely. I do agree with the administrative settlement procedure if there are proper safeguards put on it.

I know from my own experience in working with legal counsels in tax controversies over the years that there are times when the Government is foredoomed to litigate something. They've had word from the Justice Department or the chief counsel's office that we have got a conflict in the circuits or we are trying to get a conflict in the circuits; we are going to litigate this so just pack up your file and go home.

Now I don't think a taxpayer in his good judgment or that of this counsel or adviser should be burdened with the fact of having to sit down and go through laborious administrative procedures to aggrandize the ego of the Government.

I think, on the other hand, if the Commissioner would tell him or give him something in writing and say, "We understand our policies. We feel we honestly can maybe settle this or we have the authority or the latitude to settle this administratively, then I think he should be required to exhaust his administrative remedies. Now where they start and end is something else. It may be a little difficult to ascertain.

I think, though, one of the things by allowing the administrative expenses, it would encourage more administrative procedures. I think from experience that I can tell you they are sometimes a little less expensive than in litigation, especially if you go all the way from the lower courts into the U.S. Supreme Court. They would be encouraged to do it if they know. But I think the Commissioner should be in a position to assure him that it is not an issue he has foredoomed to litigate. If he will do that, then I don't think anybody could have a quarrel with that.

Now I agree with the situation that the Government should have the test of unreasonableness rather than bad faith. And the test of the burden of proof because, as it has been ably testified to before me here today, they have got the files.

I think there was one subcommittee chairman at the last hearing I attended that put it as the sauce for the goose or the quid pro quo. If the taxpayer makes honest disclosures then the Government should do the same because I don't believe in either one of them sitting back. I don't believe in the Government hiding an informer's letter and trying to bottom their case on it. If they have got an informer's letter in their files and they try to hide under the Freedom of Information Act, apparently you cannot touch it. I think they should require both sides to do it.

Several bills are pending in both the House and the Senate. And the question of—what are reimbursable costs? Now, of course, attorney's fees are very definitely spelled out. Some say expert witnesses or preparation of cases. Possibly, the courts may want a little more definition as to what is intended there. In other words, whether or not he testifies or not, he may be instrumental in preparing the accounting records; he may be instrumental in preparing the medical reports or giving depositions or something on a medical case or a personal injury case or something involved in the tax thing.

But I think it should possibly be spelled out a little more either in the statute or in the committee reports.

Again, as I said, I think the burden of proof should stay with the Government because, as I said, they have their files there. And they can sometimes secrete things. I don't say they deliberately do it, but I mean because of their—as Mr. Egger, I believe, testified, he has 50,000 agents out in the field. And the line of communication gets a little frayed in there sometimes. So I think they should be required to come up with their share of it.

Now the thing that I have not been able to ascertain from the Treasury people in the last year or 2 or 3 that this type legislation has been pending, Treasury comes back and Justice comes back and says that they are horrified at the prospect of the cost. Now, as I said, I don't advocate abridging the Government's right to do anything they are entitled to do. And I think the court that tried the case, if it is a litigated case, should be the one to make the determination if there has been unjust treatment of the taxpayer. Now if the Secretary of the Treasury and the Commissioner are not doing something that they aren't supposed to be doing or haven't told Congress or the taxpaying public, then I think they have got nothing to worry about in the way of costs now.

Another important thing that I don't think has been addressed, Mr. Chairman, is the matter of the awarding of fees should the law be enacted to provide the awarding of administrative costs. Now I have been told by some of my legal friends that you could not get a court to come in that had never seen the case or never heard it even if it is a pretrial settlement—get in to make a determination about whether the taxpayer was treated unjustifiably. I do have friends in the legal profession that act as professional arbiters. And they say they are available in all fields of expertise. Arbitration is an American process that is well accepted. And I think throughout the world it is accepted. But I think there should be some preagreement or some prestatutorily designated person or board or source to make a determination about the unjustifiableness of the way the taxpayer was treated.

In the matter of determining whether or not a taxyear has prevailed, this should be done on an issue by issue basis rather than taken as a whole because there are frequently several wholly unrelated issues which should be judged on their individual merits.

Mr. Chairman, in the interest of saving this committee's valuable time, I will let my written statement speak for the rest of it. And I thank you and the committee for this opportunity. I will be glad to assist in any way I can.

[The prepared statement follows:]

STATEMENT OF EDWIN I. DAVIS
BEFORE THE SUBCOMMITTEE ON
OVERSIGHT OF THE INTERNAL REVENUE SERVICE
OF THE COMMITTEE ON FINANCE
UNITED STATES SENATE
OCTOBER 19, 1981

Mr. Chairman and other distinguished members of this subcommittee, I appreciate very much the opportunity of being able to appear before you today as you consider the effects on tax litigation of the Equal Access to Justice Act, P.L. 96-481. I consider it necessary for truly equal access to justice that the government reimburse the litigation costs of taxpayers who are determined to have been unjustifiably subjected to burdensome and expensive litigation in order to prove that their federal tax returns were correct in the first place. I believe there is an increasing need to give our general taxpaying public confidence that they really do have equal access to justice if we are to maintain our self assessment taxation system.

By way of introduction, I am a practicing Certified Public Accountant and have my own accounting practice in the Houston, Texas area where I have dealt with a wide variety of tax matters for approximately 30 years. I do not appear as a representative of any professional or advocacy groups, but merely as an accounting and tax practitioner. Obviously, both I and my clients are interested in the general subject

of reimbursement of certain tax controversy costs to taxpayers. I have testified previously at three other similar hearings: on July 19, 1979, before this Subcommittee on S. 1444 (introduced by Senator Max Baucus), and on October 6, 1980, before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means of the U.S. House of Representatives in Los Angeles, California, on H.R. 4584 (introduced by former Congressman James Corman), and on September 10 of this year before the Select Revenue Measures Subcommittee of the House Ways and Means Committee on H.R. 1095, H.R. 2555 and H.R. 3262. Neither bill from the last Congress reached the floor. However, I believe there is very keen interest in the general subject among a large number of members of both Houses of Congress, and I can assure you that there is widespread interest in the subject among tax practitioners and taxpayers alike.

As I understand the purpose of this hearing, it is to review the potential effects on tax litigation of P.L. 96-481. Most types of litigation with the government, including tax litigation are covered by the cost reimbursement rule contained in P.L. 96-481. In its latter stages the bill that became P.L. 96-481 was amended to delay the effective date of such law as it pertained to tax litigation, to enable Congress to consider and enact measures to deal specifically with tax litigation.

As you know, various alternatives to P.L. 96-481 are contained in bills pending before both the House of Representatives and the Senate:

1. H.R. 2555 introduced on March 17, 1981, provides that the Court having jurisdiction of the litigation may, in its discretion, award a prevailing party reasonable attorneys' fees and costs. This bill does not expressly provide for reimbursement of costs for other professional assistance (C.P.A.'s, engineers, appraisers, etc.), nor does it provide for reimbursement of costs incurred in administrative proceedings or in matters settled before trial.

2. H.R. 3262 introduced on April 27, 1981, among other things, sets a $20,000 maximum dollar amount on the award. This bill is somewhat more expansive in describing the "prevailing party" entitled to the award, and it does provide that either the court or the parties by agreement could make the decision as to who prevailed. Costs for other professional assistance are reimbursed only if they involve a study or similar analysis found "necessary" by the court. As in H.R. 2555, the bill does not provide for any costs incurred in administrative proceedings or matters settled before trial.

3. H.R. 1095 introduced on January 22, 1981, covers all litigation arising from any legal action originally initiated by the government. It specifically also includes any action instituted by a taxpayer contesting the accuracy of a deficiency assessment or claiming a refund of taxes paid. Under this bill the government would reimburse in full the reasonable litigation cost incurred by the taxpayer who prevails or substantially prevails. It is not clear to me whether the reimbursed litigation cost would include

costs of other professional assistance where no expert testimony was involved. Further, the bill does not provide for costs incurred in administrative proceedings or for matters settled before trial.

4. S.752, introduced on March 19, 1981, provides another alternative for reimbursement of certain costs of tax litigation. S.752 provides for court award of reasonable court costs, including attorney's fees, to prevailing taxpayers under substantially the same circumstances and limits contained in S.1444 (on which bill I have previously testified).

5. S.1673, introduced on September 28, 1981, contains the same provisions as H.R. 3262 (discussed above), except that the dollar limit for reimbursement is $25,000 rather than $20,000.

From my experience as a former Internal Revenue Service agent and as a private practitioner, I am certain that there will always be bona fide and honest disagreements between taxpayers and their representatives on the one hand, and the Internal Revenue Service on the other. I am just as certain that in other exceptional cases, taxpayers have been unjustifiably forced to defend administratively, and in our court systems, correct legal positions taken on their tax returns. For taxpayers with limited resources due to inflation and other factors, this can create significant financial problems. For any taxpayer, a decision to resist and possibly end up in litigation requires a decision to pay high costs for professional assistance and to expend a great amount of time preparing for and participating in a trial. I am sure

the members of this Subcommittee are aware of situations among their constituents in which a taxpayer has said that he believes he is right - he frankly knows he's right - but because of the high litigation costs and the amount of time demanded to resist, he feels obliged to pay the amount claimed in order to get on with a more productive effort.

At the same time, I do not advocate enactment of legislation that would give the taxpayer a free license and permit to litigate indeterminably. I also do not advocate prohibiting or restraining the Internal Revenue Service in any manner from performing any legitimate duties or examinations of a taxpayer and his records which the law permits. For example, some persons propose to reimburse all costs to a taxpayer from the instant the taxpayer is first contacted by an examiner from the Internal Revenue Service. In my mind this is highly impractical and unfair to the government because the government should not be discouraged from auditing the correctness of tax returns. They must, however, be discouraged from insisting on unreasonable and unfair positions. The interests of the government and the taxpayer must both be balanced.

Upon review of P.L. 96-481 and the various alternatives before the Congress, I would like to make several specific recommendations to this Subcommittee:

1. If the taxpayer chooses to litigate, the court that heard the controversy should have the discretion to award costs to a prevailing taxpayer or not, based on its

view of whether the government has acted unjustly. I doubt that the courts need any other, more definitive standards.

2. Most tax controversies are settled at the administrative level or prior to trial. To avoid discouraging settlements, it may be appropriate to reimburse administrative appeal costs, also, under appropriate standards. It might be impractical to provide that a court would have jurisdiction to decide the award of costs and fees in a matter not before it. Perhaps the process of arbitration by an arbiter designated under the law or by mutual agreement between the parties could be a solution.

3. In deciding whether a taxpayer is entitled to reimbursement, whether or not the government has acted unjustly should be considered separately for each issue, and reimbursement confined to the cost of contesting the unjust issues. Frequently cases contain many unrelated issues, and the position of the Internal Revenue Service may be meritorious as to some issues and unjustified as to others.

4. The maximum costs to be reimbursed should not be a fixed dollar amount, but should be related to the amount involved, or be a per diem rate, or perhaps be limited to an amount not in excess of what the government expends for its handling of the matter during the existence of proceedings subject to reimbursement.

5. Attorneys handling either administrative or litigation proceedings find it necessary to employ other professionals in the preparation and presentation of their cases. I refer to services of accountants, engineers,

doctors, appraisers, and other professionals who may work on the litigation "team" but who are not intended to be expert witnesses. These costs should definitely be covered in the reimbursable costs. Necessary out-of-pocket expenses for travel and the like should also be covered.

There has been in the past, and undoubtedly will be in the future, concern that awarding litigation costs will subject the government to large, indeterminate liabilities. My answer to that is simply that if the Internal Revenue Service conducts itself properly, i.e., if it does not put a taxpayer in a position where he is unjustifiably faced with the alternative of either paying a tax or putting forth considerable financial resources and efforts to defend his position, then there is nothing to worry about. If the government believes large costs could result, then the Internal Revenue Service must be taking too many unjustifiable positions.

In conclusion, I believe the awarding of attorneys' fees and other professional fees and costs, under proper circumstances, to taxpayers is an important matter to be dealt with by this Congress, particularly to restore the confidence of the taxpaying public in the integrity of our tax system and to preserve the self assessment system which has existed for many years.

I appreciate the opportunity of being heard today, and I would certainly welcome any questions or any other opportunity to assist this Subcommittee.

Senator GRASSLEY. I have one question I want to ask.

Mr. DAVIS. Yes, sir.

Senator GRASSLEY. How would you draw the balance between the taxpayer and the IRS in allowing the recovery of attorney's fees for administrative appeals within the IRS where the taxpayer prevails in the Tax Court?

Mr. DAVIS. I'm sorry, sir. I didn't quite——

Senator GRASSLEY. In the process for determining costs, like for attorney's fees——

Mr. DAVIS. Yes, sir.

Senator GRASSLEY [continuing]. Where in the administrative process would you start that tabulation of when the taxpayer is going to have attorney's fees awarded when it later on ends up in Tax Court?

Mr. DAVIS. Mr. Chairman, I would say not before the Revenue agent's report comes out because prior to that time he may have an academic exercise. The agent is doing what he is entitled to do. And you don't really have a controversy locked in until you pass that point.

Now when he gives you that letter in writing saying that we propose an adjustment to your income which will result in x dollars of tax, then you are coming to a controversy. Possibly after that time, but I would say not before that time.

Senator GRASSLEY. Thank you very much.

Mr. DAVIS. Thank you, sir.

Senator GRASSLEY. The hearing is closed.

[Whereupon, at 4:05 p.m., the hearing was adjourned.]

[By direction of the chairman the following communications were made a part of the hearing record:]

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October 30, 1981

The Honorable Robert Dole
Chairman, Senate Committee on Finance
2227 Dirksen Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

I am writing on behalf of Kelly Niles, a severely crippled young man who has recently won a significant tax victory in federal district court, to urge that the effective date provisions of section 3 of S. 752 be amended to read as follows:

> The amendments made by this title shall apply to civil actions or proceedings which are pending on, or commenced on or after, December 31, 1980, and before January 1, 1991. [Changes underscored.]

Without this change, Mr. Niles would not be entitled to reimbursement of his attorneys' fees under the current language of S. 752, the "Taxpayer Protection and Reimbursement Act." The cost of Mr. Niles' victory was made particularly burdensome by the misconduct and deliberate deception practiced by the Internal Revenue Service, and we urge that his circumstances present a compelling case for liberalization of the effective date provisions of section 3 of S. 752 to cover taxpayers in Mr. Niles' position.

Not only will this change enable Kelly Niles and others similarly situated to be candidates for relief under the Act, but it will also place in S. 752 a parallel effective date mechanism -- tying the effective date to pending actions -- to that used in both the Civil Rights Attorneys' Fees Awards of 1976 and the Equal Access to Justice Act of 1980.

The Kelly Niles case itself presents an appealing case for relief; at least he should not be deprived of the opportunity to prove that he is entitled to an award of legal fees from the government in the particular facts of his case. In 1970,

Mr. Niles, then eleven years old, suffered a head injury as a result of a playground accident. Subsequent negligent medical care left him with irreparable brain damage. While Mr. Niles retains full use of his intellect (his I.Q. has been tested at 143), he has lost virtually all voluntary motor control over his body. Mr. Niles is entirely unable to speak or to care for himself and requires the services of three full-time attendants. He suffers severe medical disorders, including epilepsy, osteoporosis, and scoliosis, which have necessitated surgery in the past and most likely will do so in the future. Mr. Niles' life expectancy, however, remains normal.

A personal injury action in 1973 resulted in a jury verdict awarding an unallocated lump sum of $4,025,000. On appeal, the defendants attacked the size of the verdict as excessive. Solely as a means of supporting the size of the award on appeal, attorneys for Mr. Niles made a hypothetical itemization of the award, allocating portions to possible components such as compensation for future medical expenses and loss of future earnings. The California District Court of Appeal affirmed.

In 1978, the IRS asserted income tax deficiencies against Mr. Niles for the years 1973 through 1976 on the grounds (1) that certain medical expenses incurred by Mr. Niles after the personal injury action had been "compensated for" by the personal injury award and therefore were not deductible under section 213 of the Internal Revenue Code and (2) that the portion of the personal injury award representing compensation for his lost earning ability was taxable income to him as a substitute for wages. After paying the tax, Mr. Niles filed a suit for refund. In the course of the litigation, the government was made to recognize that its second contention was directly contradicted by section 104 of the Internal Revenue Code and it eventually conceded the issue. However, it pursued the medical expense issue with a vengeance. On August 11, 1981, the U. S. District Court for the Northern District of California granted summary judgment in favor of Mr. Niles. The court held that ". . .the IRS may not break up a lump sum jury award in [a] personal injury action so as to allocate the hypothetical portion thereof to future medical expenses and to bar the deduction of such expenses as having been previously compensated for."

In its effort to extract the unowed tax from Mr. Niles, the IRS not only pursued one issue on which it was clearly wrong

but deliberately attempted to deny Mr. Niles a fair hearing, worked various deceits upon Mr. Niles and the Court and denied Mr. Niles due process of law by flagrantly ignoring administrative procedures required by its own regulations.

In April 1979, at an early administrative stage of the tax controversy, we wrote to the Chief Counsel of the IRS on Mr. Niles' behalf, pointing out policy shortcomings which we perceived in the IRS's legal theory and urging that, as a matter of sound and enlightened tax administration, the IRS cease its efforts against Mr. Niles. In June 1979, the Chief Counsel's office responded that it saw no reason to intervene and that the matter would be handled in the normal course through the San Francisco district office of the IRS. In fact, however, as we subsequently had to determine through a combination of Freedom of Information Act Requests and interrogatories, the Chief Counsel was simultaneously treating our letter, and Mr. Niles' situation, as the basis for a revenue ruling (published in late 1979 as Revenue Ruling 79-429) supporting the IRS's litigation posture. In publishing the ruling, the IRS violated its own regulations, which require notice to the taxpayer and an opportunity for a hearing if the IRS proposes to issue a ruling adverse to a specific taxpayer.

In addition, in its brief opposing Mr. Niles' motion for summary judgment in U. S. District Court, the government stated (without supporting affidavits or evidence) that its position regarding Mr. Niles' medical expenses was consistent with its longstanding administrative practice. In fact, however, as demonstrated by two letter rulings previously issued by the IRS which directly held in Mr. Niles' favor, the IRS's administrative practice had been exactly the opposite of its litigation posture in Mr. Niles' case.

As shown in Exhibit A attached hereto, the IRS was thwarted in its attempts to use deceptive practices. The Court refused to allow the IRS to rely upon Revenue Ruling 79-429, stating that it would "not allow the Service to take advantage of a self-serving ruling, and therefore it will not be followed." The Court also rejected the government's claim of past administrative practice: "Plaintiff has cited two Letter Rulings which unequivocally indicate that the Service's past administrative position was not to allocate lump sum personal injury awards to disallow future medical expenses."

There was thus no legal basis for the IRS pursuing either of the principal issues in the case. Moreover, the IRS's egregious conduct has caused Mr. Niles' defense to be very costly.

The Equal Access to Justice Act of 1980 provides for the award of reasonable fees and expenses of attorneys, in addition to other costs, to the prevailing party in any civil action brought by or against the United States, unless the court finds that the position of the United States was substantially justified or that special circumstances make an award unjust. The legislative history of the Act indicates that:

> The test of whether or not a Government action is substantially justified is essentially one of reasonableness. . .A court should look closely at cases, for example, where there has been a judgment on the pleadings or where there is a directed verdict or where a prior suit on the same claim has been dismissed. Such cases clearly raise the possibility that the Government was unreasonable in pursuing the litigation.

H.R. Rep. No. 96-1418, 96th Cong., 2d Sess., U.S. Code Cong. & Ad. News 4989 (1980). In light of the particular facts in this case, including the IRS's conduct, we think it is probable that Mr. Niles would be able to recover attorneys' fees and costs under the standard set forth above. Moreover,

> [t]he bill rests on the premise that a party who chooses to litigate an issue against the Government is not only representing his or her own interest but is formulating public policy. . . The bill thus recognizes that the expenses of correcting an error on the part of the Government should not rest wholly on the party whose willingness to litigate [o]r adjudicate has helped to define the limits of Federal authority. Where parties are serving a public purpose, it is unfair to ask them to finance through their tax dollars unreasonable Government action and also to bear the costs of vindicating their rights.

H.R. Rep. No. 96-1418, supra at 4988. Surely Mr. Niles' situation falls within the policy upon which the Act was based.

Indeed, in the tradition of the "private attorney general," his courageous stand vindicated the rights of many others similarly situated.

Mr. Niles nonetheless appears ineligible for compensation under the Act because of the Act's limitation of relief to individuals with net worth of no more than $1,000,000. Due solely to Mr. Niles' personal injury award, his financial "net worth" exceeds the Act's ceiling, although arguably his net worth is much less if one considers the fact that it is burdened with substantial obligations. Indeed, using what we believe are reasonable assumptions, it is possible (as shown in Exhibit B) that his assets will be completely exhausted by the time he attains age 52. While we think persuasive arguments could be advanced that the Act's net worth provision should be amended to exclude compensation for personal injury from the computation of "net worth," S. 752 as now drafted would resolve the problem by removing the net worth limitation altogether. However, S. 752 still will not help Mr. Niles if enacted in its present form because its effective date provision, section 3 of the bill, limits relief to "civil actions or proceedings filed after December 31, 1980," whereas Mr. Niles' tax refund action was filed May 2, 1980.

Mr. Niles' is clearly a case deserving of the relief which S. 752 would provide, and we urge that section 3 of the bill be amended to allow such relief by setting forth an effective date based in part upon actions pending on December 31, 1980.

Thank you for your consideration. I or my partner, Glenn Smith, will be pleased to elaborate on the foregoing or to help in any way we can with regard to this matter.

Very truly yours,

Jerry H. Robinson

Attachments

EXHIBIT A

IN THE UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF CALIFORNIA

---oOo---

KELLY B. NILES, by and through his Co-Conservators, DAVID F. NILES and JOHN A. MacMAHON,

Plaintiff,

vs.

UNITED STATES OF AMERICA,

Defendant.

NO. C-80-1733-MHP

OPINION

This is an action for refund of federal income taxes in which both parties have moved for partial summary judgment. Jurisdiction is based on 28 U.S.C. §§ 1346(a)(1) and 1402(a)(1).

The essential facts of the case are not in dispute. In 1970 plaintiff Kelly Niles, then eleven years old, suffered a head injury during a playground altercation. Subsequent negligent medical care left plaintiff with irreparable brain damage. Mr. Niles is now a quadriplegic, entirely unable to speak or to care for himself and requiring the services of three full-time attendants. He suffers severe medical disorders including epilepsy, osteoporosis, and scoliosis which have necessitated surgery in the past and most likely will do so in the future. Mr. Niles' life expectancy remains normal. His intellect, tested at 140 prior to the injury, is active and intact.

A personal injury action in 1973 resulted in a lump sum jury award of $4,025,000. The verdict was attacked as excessive, but the California Court of Appeal affirmed. Niles v. City of San Rafael, 42 Cal. App. 3d 230, 116 Cal. Rptr. 733 (1974). Defendant Internal Revenue Service ("IRS"

or "Service") does not contest the fact that the personal injury award was properly excluded from Mr. Niles' gross income under Section 104(a)(2) of the Internal Revenue Code ("Code"). 1/

In 1978 the IRS asserted income tax deficiencies against Mr. Niles for the calendar years 1973 through 1976 in the total amount of $644,341. The Service bases the deficiency on the grounds that: (1) certain medical expenses incurred since the personal injury action were deducted improperly; (2) certain expenses relating to Mr. Niles' care were not deductible medical expenses within the meaning of Section 213 of the Code; (3) a portion of the personal injury award represented reimbursement for past medical expenses and therefore was taxable as gross income; (4) a portion of the award was allocable to the loss of Mr. Niles' future earnings and thus constituted taxable income; and (5) the post-judgment interest paid to Mr. Niles by the defendants in the personal injury action also was taxable income. Mr. Niles paid the deficiency assessed for 1975. He subsequently filed this refund action.

Only three issues are before the court at this time on the motions for partial summary judgment. They are:

(1) Does section 213(a) of the Code preclude deductions of future medical expenses compensated by personal injury awards?

(2) Does the Service have the authority to allocate a portion of a lump sum jury award to cover future medical expenses?

(3) Given the applicable standard of review, has either plaintiff or defendant established the absence of a genuine issue of material fact, such that summary judgment is appropriate?

The parties represent that all other issues have been or soon will be resolved.

APPLICABILITY OF SECTION 213(a) TO PERSONAL INJURY AWARDS.

Section 213(a) of the Code allows the deduction of medical expenses "not compensated for by insurance or otherwise . . ." (emphasis added). Briefly stated, the IRS contends that a portion of Mr. Niles' lump sum personal injury award can be allocated to cover future medical expenses and that this portion of the award represents compensation within the meaning of section 213(a). Because Mr. Niles has been compensated for future medical expenses, argues the Service, he is precluded from deducting medical expenses incurred since receipt of the award until such expenses exceed the allocated amount. The IRS contends that section 213(a) must be so interpreted to prevent Mr. Niles from receiving a double tax benefit unintended by Congress.

Plaintiff contends that personal injury awards are excluded from taxable income because they represent a return of capital. By enacting this exclusion, Congress intended to place an injured party, through financial reimbursement, in the same position as he or she was in prior to the loss. Plaintiff reasons that the exclusion therefore cannot be considered a form of economic benefit and should not interfere with Mr. Niles' deduction of future medical expenses.

It is unnecessary to reach the merits of this issue because consideration of the second question will be dispositive of the motions for summary judgment.

AUTHORITY OF THE IRS TO ALLOCATE LUMP SUM PERSONAL INJURY AWARDS.

Regardless of whether the statutory language of section 213(a) precludes deductions of future medical expenses for which compensation has been received in the form of

personal injury awards, the threshold question is whether the IRS has the authority to allocate a portion of a lump sum jury award in a personal injury action to future medical expenses. The issue is one of first impression. Defendant correctly asserts, however, that in refund actions, plaintiff has the burden of proving "all facts necessary to establish the illegality of the collection." Niles Bement Pond Co. v. United States, 281 U.S. 357, 361 (1930); Roybark v. United States, 218 F.2d 164, 166 (9th Cir. 1954).

The IRS does not contest the fact that the jury in the Niles personal injury action returned an unallocated award. Citing several revenue rulings and numerous cases, however, defendant argues that the taxpayer is required to allocate a portion of lump sum verdicts to future medical expenses, and that where the taxpayer has failed to allocate, the Service will do so based on the best evidence possible. The Service further claims that such action is consistent with its past administrative procedure. In the case of Mr. Niles, the IRS contends that the best evidence available is plaintiff's own hypothetical itemization of the award presented to the California Court of Appeal to rebut the challenge of excessiveness. Using plaintiff's breakdown, the IRS asserts that $1,588,176 of the award must be allocated to future medical expenses.

As correctly noted by plaintiff, the defendant has not provided this court with any authority to substantiate its position, with the exception of Revenue Ruling 79-427, 1979-2 C.B. 120. Rather, the rulings and cases relied upon by the IRS concern the deductibility of past medical expenses, e.g., Cooney v. Commissioner, 30 T.C.M. (CCH) 845 (1971); Morgan v. Commissioner, 55 T.C. 376 (1976); Revenue Ruling 75-230, 1975-1 C.B. 93, or settlements and judgments already

already allocated by agreement of the parties involved or by the court, e.g., Spangler v. Commissioner, 323 F.2d 913 (9th Cir. 1963); Revenue Ruling 75-232, 1975-1 C.B. 94. Both situations are inapposite to the case at bar.

The amount of medical expenses paid and deducted by a taxpayer prior to settlement or judgment can be ascertained precisely, as it is a sum certain. Revenue Ruling 75-230, 1971 C.B. 93. Allocating a portion of a lump sum settlement to such prior expenses therefore can be accomplished without speculation as to the amount involved. The Service itself emphasizes this fact in Ruling 75-230 which pointedly contrasts the specificity of past medical expenses with the speculative nature of damages sought for pain and suffering. Similarly, there can be no question about the amount of any portion of a settlement or verdict that has been explicitly allocated to future medical expenses.

Plaintiff argues that the same cannot be said for an allocation of a general jury verdict to future medical expenses. This court agrees. Permitting the IRS to allocate a portion of a lump sum award to such expenses essentially is allowing the Service to hypothesize the manner in which the jury evaluated the evidence in determining what it felt to be the appropriate amount of damages to award Mr. Niles. Speculation of this nature runs contrary to the essential characteristics of the general verdict. As Judge Frank, a leading critic of the general verdict system, noted, "[t]here are . . . three unknown elements which enter into the general verdict; (a) the facts; (b) the law; [and] (c) the application of the law to the facts." Skidmore v. Baltimore & O.R.R. Co. 167 F.2d 54, 60 (2d Cir. 1948); see generally Statement of Mr. Justice Black and Mr Justice Douglas re the 1963 Amendments to Rules of Civil Procedure for the United States

District Courts, 374 U.S. 865, 867 (1963); Wright, The Use of Special Verdicts in Federal Courts, 38 F.R.D. 199 (1965); Green, The Submission of Special Verdicts in Negligence Cases, 17 U. Miami L. Rev. 469 (1963); Comment, Special Verdicts: Rule 49 of the Federal Rules of Civil Procedure, 74 Yale L.J. 483 (1965). It is because the general verdict "affords no satisfactory information about the jury's findings," 167 F.2d at 56, that courts traditionally have refrained from engaging in the kind of speculation proposed by the IRS and instead have accorded particular deference to them. See, e.g., Lavender v. Kurn, 327 U.S. 645, 653 (1946); Lang v. Texas & Pac. Ry., 624 F.2d 1275, 1278 (5th Cir. 1980).

For example, where a matter is tried on alternate theories of recovery and a general verdict rendered, appellate courts will not "speculate on what particular ground the jury may have found against [the] plaintiff . . . ." Hope v. Arrowhead & Puritas Waters, Inc., 174 Cal. App. 2d 222, 227, 344 P.2d 428, 431 (1959). See also United N.Y. & N.J. Sandy Hook Pilots Ass'n v. Halecki, 358 U.S. 613, 619 (1959)("a new trial will be required, for there is no way to know that the invalid claim . . . was not the sole basis for the verdict"); accord, Morrissey v. National Maritime Union, 544 F.2d 19, 26-27 (2d Cir. 1976). In California particularly, there is longstanding judicial deference to general verdicts. A general verdict will be upheld if sufficient evidence supports at least one of several alternate theories of recovery. This is true even where there is little or no evidence to sustain another theory also submitted to the jury. Gillespie v. Rawlings, 49 Cal. 2d 359, 369, 317 P.2d 601, 607 (1957); Louisville Title Ins. Co. v. Surety Title and Guar. Co., 60 Cal. App. 3d 781, 786-87, 132 Cal. Rptr. 63, 67 (1976). If the verdict is appealed, the California courts refuse to

conjecture about jury deliberations, holding instead that appellants' remedy was to have requested a special verdict at the time of trial. Rodgers v. Kemper Constr. Co., 50 Cal. App. 3d 608, 617, 124 Cal. Rptr. 143, 148 (1975); McCloud v. Roy Riegels Chems., 20 Cal. App. 3d 928, 936-37, 97 Cal. Rptr. 910, 915 (1971).

Similarly, where a jury verdict is attacked as excessive, all presumptions are in favor of the award, Bertero v. National General Corp., 13 Cal. 3d 43, 61, 529 P.2d 608, 621, 118 Cal. Rptr. 184, 197 (1974), because "[t]he amount of damages is a fact question . . . committed to the discretion of the jury," Seffert v. Los Angeles Transit Lines, 56 Cal. 2d 498, 506, 364 P.2d 337, 342, 15 Cal. Rptr. 161, 166 (1961). A reviewing court will interfere only if the amount "is so large that, at first blush, it shocks the conscience and suggests passion, prejudice or corruption on the part of the jury." Id. at 507, 364 P.2d at 342, 15 Cal. Rptr. at 166; accord, Uva v. Evans, 83 Cal. App. 3d 356, 363-64, 147 Cal. Rptr. 795, 800 (1978). The existence of passion or prejudice is to be determined by the entire record, including the evidence, in each case. Daggett v. Atchison, T. & S.F. Ry., 48 Cal. 2d 655, 666, 313 P.2d 557, 564 (1957); Neumann v. Bishop, 59 Cal. App. 3d 451, 491, 130 Cal. Rptr. 786, 813 (1976); Henninger v. Southern Pac. Co., 250 Cal. App. 2d 872, 883, 59 Cal. Rptr. 76, 83-84 (1967). Under these circumstances, therefore, a hypothetical breakdown of the general verdict is simply one means of demonstrating that substantial evidence supports the amount of the award. Compare Seffert v. Los Angeles Transit Lines, 56 Cal. 2d 498, 506, 364 P.2d 337, 342, 15 Cal. Rptr. 161, 166 (1961), with Torres v. City of Los Angeles, 58 Cal. 2d 35, 54, 372 P.2d 906, 918, 22 Cal. Rptr. 866, 878 (1962),

and Neumann v. Bishop, 59 Cal. App. 3d 451, 489-92, 130 Cal. Rptr. 786, 812-14 (1976). Appellate courts, however, are quite cognizant that such allocations are only "estimates," see, e.g., Seffert v. Los Angeles Transit Lines, 56 Cal. 2d at 506, 364 P.2d at 342, 15 Cal. Rptr. at 166, and that it is impossible to discern from a general verdict just how the jury apportioned the amount of damages to arrive at the total sum awarded, Henninger v. Southern Pac. Co., 250 Cal. App. 2d 872, 884, 59 Cal. Rptr. 76, 84 (1967). Thus, hypothetical itemizations of general verdicts are regarded merely as useful tools in determining whether the substantial evidence standard has been met and not as an accurate documentation of the jury's own apportionment of the damage awarded.

The Service contends that the concepts embodied in Revenue Rulings 75-230, 1975-1 C.B. 93, and 75-232, 1975-1 C.B. 94, together require it to allocate a lump sum award to future medical expenses based on the best evidence possible. Citing Revenue Ruling 79-427, 1979-2 C.B. 120, the Service further argues that the best evidence possible in cases involving unallocated personal injury awards is the amount of future medical expenses theoretically allocated by the plaintiff. By adopting plaintiff's own itemization of the award, which itemization is consistent with the pleadings and supported by extensive evidence and testimony at trial, the IRS maintains that the amount attributable to future medical expenses can be ascertained with certainty.

At first blush defendant's reasoning is attractive. It is, however, untenable. A clear reading of Revenue Rulings 75-230 and 75-232 does not lead to the conclusion that the IRS may allocate a portion of general verdicts to future medical expenses. As plaintiff correctly points out, both Rulings concerned pre-established figures. The Service does

not explain, nor do we understand, how rulings permitting allocations involving pre-established figures justify the IRS in attributing a portion of unallocated lump sum personal injury awards to future medical expenses, whenever these expenses are an element of damages.

Reliance on Revenue Ruling 79-427 in support of the Service's novel position is unacceptable. This Ruling admittedly is based on the very facts of this case. The court will not allow the Service to take advantage of a self-serving ruling, and therefore it will not be followed. Estate of Morgan v. Commissioner, 52 T.C. 478, 484 (1969), aff'd per curiam, 448 F.2d 1397 (9th Cir. 1971); Pauley v. United States, 11 A.F.T.R. 2d 955, 960 (S.D. Cal. 1963). Cf. Estate of Lang v. Commissioner, 613 F.2d 770, 776 (9th Cir. 1980)(though court gives some weight to established, reasonable revenue rulings, it will not defer to an unreasonable ruling promulgated during the life of the controversy at issue).

Defendant's contention that it has authority to use plaintiff's hypothetical itemization of the jury verdict is the most promising rationale it has offered. In determining whether a lump sum represents ordinary income or a return of capital, the courts traditionally have looked to the underlying nature of the claim, asking "[i]n lieu of what were the damages awarded?" Raytheon Prod. Corp. v. Commissioner, 144 F.2d 110, 113 (1st Cir.), cert. denied, 323 U.S. 779 (1944); Spangler v. Commissioner, 323 F.2d 913, 916 (9th Cir. 1963); Farmers' & Merchants' Bank v. Commissioner, 59 F.2d 912, 913 (6th Cir. 1932). "[T]he nature of the recovery is to be determined from the claims made in the pleadings or complaint filed in the prior action and the issues and evidence there presented to the jury." State Fish Corp. v.

Commissioner, 48 T.C. 465, 474 (1967)(citations omitted). However, the Service's reliance on this line of reasoning is misleading in the context of the present action.

As plaintiff correctly argues, the nature-of-the-claim test and the pleadings and evidence in the underlying action have been employed only to determine the characterization of the entire verdict or settlement for tax purposes. E.g., Raytheon Prod. Corp. v. Commissioner, 144 F.2d 110 (1st Cir.), cert. denied, 323 U.S. 779 (1944). They have not been used to allocate lump sum awards into component parts unless the apportionment can be made with relative certainty. Thus, for example, in Thomson v. Commissioner, 406 F.2d 1006 (9th Cir. 1969), two-thirds of a lump sum settlement in an antitrust action was allocated to ordinary income because, by virtue of the treble damages statute, 15 U.S.C. § 15, that proportion represents as a matter of law the amount of punitive damages received in successful antitrust actions. 406 F.2d at 1008. See also Spangler v. Commissioner, 323 F.2d 913, 915 (9th Cir. 1963)(amount allocated "among three elements of the judgment in accordance with the ratio between each of the elements and their sum"); Revenue Ruling 75-230, 1975-1 C.B. 93.

In this matter, however, the court is concerned with a lump sum verdict that cannot be allocated into component parts with any degree of certainty. Although it is not unlikely that the jury took into consideration future medical expenses in determining the amount of the award, it would be presumptuous of either the IRS or this court to assume to what degree and with what result. Nor can it reasonably be said that plaintiff's own itemization of the verdict lends insight into the jury's evaluation process. The breakdown was merely a hypothetical allocation submitted

to rebut the attack of excessiveness and should be treated only as such.

Contrary to defendant's allegations, allocating lump sum jury verdicts in personal injury actions has not been a long-standing administrative practice of the service. Indeed, the cases cited by the Service support the opposite conclusion. In not one instance have the IRS or the courts allocated a lump sum verdict when an apportionment could not be made with relative certainty. Furthermore, plaintiff has cited two Letter Rulings which unequivocally indicate that the Service's past administrative position was not to allocate lump sum personal injury awards to disallow future medical expenses. 2/

In Letter Ruling 6207314840A (July 31, 1962), a jury awarded the taxpayer $20,000 actual and $7,500 punitive damages. The taxpayer entered into a settlement agreement pursuant to which he received an unallocated amount of $25,000. The Service allocated the settlement into actual and punitive damages on the basis of the ratio of these damages awarded in the jury verdict.

Regarding the deductibility of future medical expenses, the Service stated:

> The taxpayer's favorable court verdict, and settlement with the other party, made no specific provision for reimbursement to them for medical expenses, but was merely a settlement made for any and all damages which they received in account of damages and injuries to their persons and property, actual and punitive. Accordingly, they may deduct their medical expenses in all years involved, subject to the provisions of section 213 of the 1954 Code, without offsetting any amount of the settlement against such expenses. . . .

The Service reiterated its position three years later in Letter Ruling 6510284440A (October 28, 1965):

> The release did not allocate any portion of the settlement to reimbursement [of] . . .

> medical expenses. Since it thus appears that [the] medical expenses have not been "compensated for by insurance or otherwise," we . . . hold that no portion of the settlement received . . . need be offset against any medical deduction [to be taken] within . . . section 213.

These rulings express the same policy that is reflected in the cases defendant cites on its behalf. When an allocation for tax purposes could be accomplished with reasonable certainty, such as using the jury's award as the basis to apportion a subsequent lump sum settlement into punitive and actual damages, the Service allocated. In the absence of such certainty, the IRS has never attempted to segregate an award into component parts.

APPROPRIATENESS OF SUMMARY JUDGMENT

A movant for summary judgment must demonstrate the absence of any genuine issue of material fact, and that he is entitled to prevail as a matter of law. Linn Gear Co. v. NLRB, 608 F.2d 791, 793 (9th Cir. 1979); Stansifer v. Chrysler Motors Corp., 487 F.2d 59, 63 (9th Cir. 1973); Fed. R. Civ. P. 56(c). In this case, the essential facts are not in dispute. On the issues of law, plaintiff has met his burden by demonstrating clearly that the Internal Revenue Service has no authority whatsoever to allocate a lump sum jury verdict to future medical expenses. Adopting plaintiff's hypothetical itemization of the award does not provide the requisite certainty necessary for apportioning a lump sum verdict. Accordingly, plaintiff's motion for partial summary judgment is granted and defendant's motion is denied.

IT IS SO ORDERED.

DATED: AUG 11 1981

MARILYN HALL PATEL

MARILYN HALL PATEL
United States District Court Judge

F O O T N O T E S

1/ All references are to the Internal Revenue Code of 1954, as amended, unless otherwise stated.

2/ While letter rulings have no precedential force, I.R.C. § 6110(j)(3) they may be used as evidence of the Service's past administrative practice. See, e.g., Rowan Companies, Inc. v. United States, 49 U.S.L.W. 4646, 4650 n.17 (U.S. June 8, 1981).

EXHIBIT B

Information about the worth of Kelly Niles' assets, as of September 30, 1981, in relation to estimated financial demands deriving from the personal injury which gave rise to the assets.

Kelly Niles' Assets

The following is a summary of Mr. Niles' assets, shown at cost, as of September 30, 1981:

Money Market Fund	$ 16,047.45
Bonds	2,363,589.65
Certificates of Deposit	475,000.00
Real Estate Investments	325,000.00
	$3,179,637.10

These assets reflect the investment of the net proceeds of the personal injury award Mr. Niles received in 1973 and 1975.

The fair market value of the bonds, all government or high-grade corporate issue, at September 30 was below cost. While the fair market value of bonds is inherently incapable of precise valuation, their realizable value at September 30, 1981 was about $2,150,000. Thus, the total value of Mr. Niles' assets at September 30 was approximately $3,179,637.10

Mr. Niles' known financial needs deriving directly from his physical condition are subtracted from the value of his assets; however, his real "net worth" is virtually zero, since his costs appear likely to exhaust his resources before the end of his life.

Kelly Niles' Financial Needs

It cost at least $140,000 to take care of Mr. Niles in 1979. This level of expenditures reflects the normal costs of caring for Mr. Niles, and, adjusted upward for

inflation, is expected to continue for Mr. Niles' normal life expectancy of 72 years -- or another 51 years. It represents his minimum annual requirements. This level of expenses assumes Mr. Niles will remain healthy throughout his life, although it is reasonable to expect that he will become ill from time to time and that these illnesses will generate significant additional expenses. Also, this level of expenditures does not purport to take into account the potential cost of taking advantage of new technology, both scientific and mechanical, which could be essential to Mr. Niles.

Notwithstanding the apparent size of the $3.179 million figure, there is very real, very legitimate concern that these assets will be totally exhausted during Mr. Niles' lifetime, based on a number of assumptions which we believe are reasonable:

1. Annual expenses for Mr. Niles' care and maintenance will be at the level of $140,000. Again, this level of expenses ignores reasonable foreseeable additional costs and therefore is, we believe, a very conservative estimate. His actual expenses for the first nine months of 1980 average $11,670 per month, for an annual rate of $140,000.

2. The annual rate of inflation will be 6%. This we also believe is a reasonable estimate, especially considering actual current levels of inflation.

3. Mr. Niles will be able to obtain an annual yield of 8% on his investments, a yield which we believe is on the high side.

Based on these assumptions, the mathematics show that his assets will be exhausted in 31 years, or when Mr. Niles attains age 52, far short of his life expectancy.

The assumptions on which this computation is based probably err in favor of prolonging rather than shortening the time when the assets will be exhausted. Thus, if a yield of only 6% is obtained instead of 8%, the assets will be exhausted in only 25 years.

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October 20, 1981

Mr. Robert E. Lighthizer
Chief Counsel
Committee on Finance
Room 2227
Dirksen Senate Office Building
Washington DC 20510

Re: Equal Access to Justice Act

Dear Mr. Lighthizer:

I would like to submit the following statement for consideration by the Senate Finance Committee on Oversight of the Internal Revenue Service on the impact of the Equal Access to Justice Act on tax litigation.

Both the taxpayer and the government should be entitled to an award of attorneys' fees in any tax case where the position maintained in the litigation by the opposing party is substantially unjustified. There is no reasonable basis for any distinction between refund cases litigated in the district courts and Court of Claims, and deficiency cases litigated in the U. S. Tax Court. The need to deter unreasonable positions and to encourage settlement is equally great in any of these forums.

Nor is there, I believe, a sound basis for imposing a net worth requirement as a condition of entitlement to the award. Clearly, if the IRS were also entitled to awards, the net worth requirement would be inappropriate as an overall proposition. The principal purpose of the awards in any event should be to deter unreasonable litigation and to encourage settlement. This purpose should be served notwithstanding the net worth of the litigants. Also, such limitations tend to be arbitrary and unfair in many cases.

I believe that the "bad faith" requirement which has been suggested is not the appropriate standard. A "bad faith"

requirement requires a showing of state of mind, would rarely be found applicable, would be an ineffective standard, and would not serve the objectives that an attorneys' fee award statute should have.

Court dockets, particularly those of the U. S. Tax Court, are clogged unreasonably with cases involving substantially unjustified positions. Examples are many ludicrous tax shelter schemes, family or constitutional trust cases and the like. While it occurs much less frequently, the IRS also on occasion asserts arbitrary deficiencies which may be found substantially unjustified. These cases are most often litigated in the Tax Court. An effective attorneys' fee award statute would assist greatly in deterring this litigation, encourage settlements, and be equitable to those who are the victims of the substantially unjustified position.

The volume of litigation, particularly in the Tax Court, has reached proportions where it is not possible for taxpayers with reasonable causes to obtain prompt resolution of their disputes. Now that interest rates on deficiencies will be in the area of 20%, it is unfair to exasperate the problem by not adopting measures which may tend to improve the situation. An attorneys' fee award statute, applicable to all parties, in all tax litigation, based on a "substantially unjustified" test would be an effective means of doing so.

Thank you for allowing me to express these views.

Yours very truly,

Thomas J. Donnelly

TJD:kas

Rt. 1 Box 87
Colcord, Ok. 74338
October 19, 1981

Robert E. Lighthizer, Chief Cousel
Committee on Finance
Room 2227
Dirksen Senate Office Building,
Washington, D. C. 20510

Re: Equal Access to Justice Act

Dear Mr. Lighthizer:

I have just roday been informed of the Equal Access to Justice Act. I would appreciate my comments being added to written statements on the Act.

I believe the Courts would be right in awarding court fees, attorney's fees, expert witness fees, and also compensation for travel and mileage, loss of time and other expenses incurred, for those who prevail over federal agencies in civil court cases and adversary administrative adjudications, including Internal Revenue Service.

I am currently trying to get IRS to make a decision on a waiver of penalty which was unjustly placed. Already I have spent many dollars and many hours responding to IRS communications, but IRS does not respond to me, and the computer keeps generating notices. If it should progress to the point where I have to take this issue to Court, I am certain the decision would be in my favor, but expenses would be incurred in such an action which could be unaffordable. For a person of my standing (starting a business and having zero taxable income) such expenses are a definite inhibition to going to court because they could easily exceed the amount of the penalty originally involved. Paying the penalty would not be just when it should not be paid in the first place, but it could cost less than Court. That means IRS would bully successfully and unjustly and do it again with a lust for money and disregard for justice.
The provision in favor of fees for the party who prevails over a federal agency in the Act should be considered as necessary for Justice, aside from the fact that the continuing existence of Legal Services Corporation is in doubt. Fees or expenses paid by a party for the sake of justice would not only be a burden to those who qualify for Legal Services, but also to those of higher income, and they ought to be paid by the party who receives the unfavorable decision, especially if fault is found.

Sincerely,

Maureen K. Johnson

Maureen K. Johnson

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