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Smoky Mountain Secrets Inc. v. U.S.

910 F. Supp. 1316

This is a tax refund action brought by the plaintiff-taxpayer, Smoky Mountain Secrets, Inc. (SMS), pursuant to 28 U.S.C. section 1346(a)(1). Plaintiff sought a refund of Form 941, Federal Insurance Contribution Act (FICA) taxes, and Form 940, Federal Unemployment Tax Act (FUTA) taxes, which plaintiff contended were assessed erroneously by the United States Department of the Treasury through the Internal Revenue Service (IRS). In a previous memorandum opinion [Doc. No. 33], the court, after a non-jury trial, held in favor of the plaintiff and ordered that plaintiff take judgment in the amount of \$2,150; that plaintiff is entitled to abatement of the taxes, interest and penalties assessed against it for non-payment of Forms 940 and 941 taxes for the years 1989 and 1990; and that defendant take nothing on its counterclaim [see Doc. No. 38]. Currently pending is plaintiff's motion to tax costs against defendant [Doc. No. 36]. For the reasons that follow, the motion to tax costs, including attorney fees, will be granted in part.

I.

The facts of this case are set forth in considerable detail in the court's findings of fact and conclusions of law [see Doc. No. 33], and will not be repeated herein. The amount of taxes, interest and penalties at issue in this litigation was considerable. The total amount of taxes assessed alone was approximately \$3,888,918.00, which did not include interest.

Three principal issues were litigated by the parties in this case. First, the court considered whether plaintiff's telemarketers and delivery persons were "direct sellers" pursuant to 26 U.S.C. section 3508. The court concluded that they were. The court next considered whether defendant was entitled to relief pursuant to section 530 of the Revenue Act of 1978. Section 530 of the 1978 Act was codified as a footnote to 26 U.S.C. section 3401. Congress intended that section 530 would serve as a shelter (for certain taxpayers who had acted in good faith) from the potentially harsh retroactive tax liabilities resulting from IRS reclassification of independent contractors as employees. The court concluded that the taxpayer-defendant in this case had indeed relied in good faith on the advice of two certified public accountants. Lastly, the court considered whether plaintiff was entitled to rely upon the prior audit safe harbor provision of section 530. The evidence was insufficient to support plaintiff's position on this issue and thus it was rejected. Therefore, plaintiff prevailed with respect to two of the three principal questions at issue in this case.

II.

A. Did plaintiff substantially prevail with respect to the amount in controversy?

[1] Section 7430(a) of Title 26, United States Code, provides generally that in a court proceeding against the United States in connection with the refund of any tax the prevailing party may be awarded a judgment for reasonable litigation costs and administrative costs incurred by the prevailing party. Section 7430(c)(4)(A) defines "prevailing party" as follows:

(i) [A party] which establishes that the position of the United States in the proceeding was not substantially justified,

(ii) which -

(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 and

(iii) which meets the requirements of the 1st sentence of section 2412(d)(1)(B) of Title 28, United States Code ... except to the extent differing procedures are established by rule of court and meets the requirements of section 2412(d)(2)(B) of such Title 28.... 1

Turning first to the second prong of section 7430(c)(4)(A)(ii), there is little question that plaintiff substantially prevailed because the court entered judgment in its favor granting the requested refund and abating taxes, interest and penalties. As noted previously, the court found that plaintiff correctly treated its telemarketers and delivery persons as direct sellers and that plaintiff had a substantial basis to rely on its accountants' advice, thus entitling it to the protection of section 530 of the 1978 Act. While plaintiff did not ultimately prevail under its alternative theory under section 530, that fact is not ultimately dispositive of its motion for costs.

B. Was the government's position substantially justified?

The question then becomes whether or not the position of the United States was substantially justified. The Supreme Court has not interpreted the phrase "substantially justified" as it appears in section 7430(c)(4)(A)(i). However, it has interpreted this phrase as it appears in the Equal Access to Justice Act, 28 U.S.C. section 2412. Numerous courts have applied the Supreme Court's EAJA interpretation to the phrase as it appears in section 7430. See, e.g. *Kenagy v. United States*, 942 F.2d 459 [68 AFTR 2d 91-5342] (8th Cir. 1991); *Weiss v. Commissioner*, 850 F.2d 111, 116 [62 AFTR 2d 88-5115] (2d Cir. 1988). The Supreme Court held that "substantially justified" means justified to a degree that could not satisfy a reasonable person. *Pierce v. Underwood*, 487 U.S. 552, 565 (1988).

Plaintiff first contends that the government's choice to force plaintiff to litigate its direct seller argument was based on a [pg. 96-7605] faulty interpretation of the direct seller provision of 26 U.S.C. section 3508. Specifically, plaintiff argues that the IRS's position that plaintiff failed to satisfy the written contract requirement of section 3508(b)(2)(C) was unreasonable because the IRS had no case authority to support this interpretation. As pointed out by the IRS, however, a position is deemed substantially justified so long as it has a "reasonable basis in fact and law" and where the government has "a solid though not necessarily correct basis in fact and law for the position it took." *Council v. United States* 89 U.S.T.C. paragraph 9535 (M.D. N.C. 1989) (quoting *McDonald v. Schweiker*, 726 F.2d 311, 316 (7th Cir. 1983)). While the government erroneously contends that the court chose to "ignore" evidence that plaintiff's telemarketers and delivery persons were really just employees, and not independent contractors, the fact remains that no case law existed before this matter was decided addressing the issue of whether telemarketers and delivery persons were actually direct sellers.

Plaintiff also argues that the IRS ignored Fed. R. Evid. 1004(1) and its application by courts in similar tax cases as a method for proving the existence of a written contract. However, as the IRS correctly points out, the burden under Rule 1004 is on plaintiff. Thus, while the court ultimately found in plaintiff's favor on the direct seller issue, this was a case of first impression. The courts have consistently refused to award attorney fees under section 7430 in such circumstances.

Accordingly, plaintiff is not entitled to any attorney fees related to time spent in connection with this issue.

Plaintiff next argues that it is entitled to an award of costs and fees because the IRS's position that plaintiff did not rely in good faith on professional advice was unreasonable. The IRS responds that plaintiff could not have relied in good faith on the advice of its accountants because they did not possess the requisite qualifications or experience in the area of employment taxation necessary to render competent advice. The IRS's position on this issue is wholly without merit. Based on its position in this court, it is readily apparent that the IRS would require a battery of accountants or lawyers, perhaps even a bevy of specialists from a Big Six firm, to render advice before a taxpayer is entitled to the protection of section 530. This position borders on the disingenuous.

Messrs. Gee and Sharpe were correct in their interpretation of section 3508, as this court ultimately found after the trial of this matter. The IRS contends that the mere fact that Mr. Gee was not aware of section 3508 indicates he did not have the requisite experience or qualifications to give what turned out to be correct advice. But as the IRS itself points out, section 3508, at the time Mr. Gee analyzed it, was only very recently enacted. This undercuts the IRS's position substantially, not to mention the fact that Mr. Gee exhaustively analyzed the statute, and carefully and systematically applied its elements to plaintiff's situation. The IRS also contends that plaintiff's president, Mr. Allen, did not disclose all relevant facts to Mr. Gee. This court, based on the all of the evidence admitted in this case, found and still finds to the contrary.

The IRS's argument regarding Mr. Sharpe's advice is even more questionable. The IRS contends that Mr. Sharpe merely relied on Mr. Gee's advice. There is no evidence of this in the record. Moreover, Mr. Sharpe did not analyze plaintiff's independent contractor issue under section 3508. Rather, Mr. Sharpe used the 20-factor test developed by the IRS to analyze whether or not plaintiff's telemarketers and delivery persons were independent contractors. Despite this overwhelming evidence to the contrary, the IRS nonetheless argued that plaintiff was not entitled to relief under section 530, even though the IRS presented no evidence which called into question the facts testified to by Messrs. Allen, Gee and Sharpe. The IRS had all of this information before trial. Nevertheless, it put plaintiff through the cost of a trial even though the IRS's position was not substantially justified in fact or in law. [pg. 96-7606]

B. Did plaintiff exceed the net worth, employee or time restrictions set forth in the statute?

The third prong of the definition of prevailing party requires plaintiff to meet the requirements of the first sentence of 28 U.S.C. section 2412(d)(1)(B) (as in effect on October 22, 1986), except to the extent differing procedures are established by rule of court and the requirements of 28 U.S.C. section 2412(d)(2)(B). As of the above-specified date, section 2412(d)(2)(B) prescribed that a corporation would not be eligible if its net worth exceeded \$7 million and if it had more than 500 employees at the time the litigation was begun. Plaintiff has filed a declaration of its president, Mr. Allen, stating that it did not have a net worth in excess of this amount and that it did not have 500 employees as of the date this litigation began. The government has not challenged this evidence. Lastly, it is clear that plaintiff has met the time requirements established by the first sentence of section 2412(d)(1)(B) by submitting its motion for costs within 30 days of the court's judgment.

III.

Having determined that plaintiff is entitled to an award of litigation costs and administrative costs incurred in this case, the court must determine whether or not the amount sought by

plaintiff is reasonable under the circumstances and recoverable under section 7430. Plaintiff seeks an award of fees as to all time expended in this case since it prevailed as to all of the relief sought. However, the government contends that, assuming plaintiff is a prevailing party under section 7430, the amount of fees should be reduced because plaintiff did not prevail as to each alternative legal ground it raised. As noted previously, the direct seller provision of section 3508 had not been applied in this context and there was no case law interpreting the statute as it applied in this case. Moreover, even though the court found against it on this issue, the facts of this unique case indicate that the IRS was justified at least to a degree that could satisfy a reasonable person. Under such circumstances, it would be inequitable to require the government to pay fees and costs regarding this novel and substantial issue.

For the reasons discussed above, however, the same cannot be said as to the government's position regarding section 530 of the 1978 Act. Section 7430(c)(1)(B)(iii) provides that:

The term "reasonable litigation costs" includes... [reasonable court costs, and,] based upon prevailing market rates for the kind or quality of services furnished... reasonable fees paid or incurred for the services of attorneys in connection with the court proceeding, except that such fees shall not be in excess of \$75 per hour unless the court determines that an increase in the cost of living or a special factor, such as the limited availability of qualified attorneys for such proceeding, justifies a higher rate.

The courts have consistently held that fees in excess of the statutory rate of \$75 per hour should not be awarded unless the court determines that an increase in the cost of living or a special factor, such as the limited availability of qualified attorneys, justifies a higher rate. See *Pierce v. Underwood*, 487 U.S. at 572; *Cassuto v. Commissioner*, 936 F.2d 736, 743 [68 AFTR 2d 91-5096] (2d Cir. 1991). The taxpayer bears the burden of demonstrating that special facts exist which justify the award of attorney fees in excess of the \$75 statutory rate. *Pierce*, 47 U.S. at 572.

In its motion and supporting memorandum and materials, plaintiff sets forth facts which justify an increase in the \$75 per hour rate using, as a base rate, the 1986 Consumer Price Index for all Urban Consumers (CPI-U). 2 Based upon the CPI-U, the statutory fees adjusted for cost of living is \$100.41 per hour in 1994 and \$103.67 per hour in 1995. Significantly, the IRS does not challenge this adjustment based upon a change in the cost of living.

Therefore, the questions as to the amount of the hourly fee is whether or not [pg. 96-7607] it should be increased based upon plaintiff's attorneys' "distinctive knowledge or specialized skill." Certainly Mr. McCarten, plaintiff's lead attorney, possesses distinctive skill in tax law. However, this alone is not enough to warrant an increase in the statutory fee. But plaintiff further contends that Mr. McCarten's distinctive knowledge on independent contractor classification issues is a special factor warranting an increased rate under the facts of this case. The court agrees.

In opposing plaintiff's request for an increased rate as to Mr. McCarten, the IRS merely states that the "special factor" relied upon by counsel is insufficient to justify an award of attorney fees in excess of the statutory amount. But nowhere does the IRS take issue with plaintiff's supporting affidavits which indicate that plaintiff could not have gotten an experienced tax litigator in Knoxville to perform the services Mr. McCarten performed for less than \$150 per hour. Therefore, the court concludes that plaintiff is entitled to an award of fees based upon Mr. McCarten's services at the rate of \$150 per hour. As to plaintiff's other attorney, Mr. Matlock, plaintiff is entitled to an award of fees based upon an hourly rate of \$100.41 for 1994 and \$103.67 for 1995. Plaintiff's request for reimbursement for the cost of services rendered by the

two accountants will be denied. Based upon the nature of this case, these costs must be borne by plaintiff.

The only remaining limitation on plaintiff's request for litigation and administrative costs is that it will not be entitled to any fees expended with regard to the section 3508 direct seller issue and the section 530 prior audit safe harbor provision. Plaintiff's counsel will be ordered to reconstruct their time expended and submit a renewed tally of the costs associated with this litigation consistent with this opinion.

Order accordingly.

1 Since the court issued its findings of fact and conclusions of law, the definition of "prevailing party" has been changed. Congress eliminated the provision requiring the party to show that the position of the United States in the proceeding was not substantially justified, thus making it easier to establish status as a prevailing party. The litigants in this case do not contend that the amended statute should apply. Therefore, the court will apply the statute in effect at the time this case was decided.

2 Section 7430 was passed in January 1986.