(4) *Examples.* The provisions of this section are illustrated by the following examples:

Example 1. Taxpayer A receives a notice of proposed deficiency (30-day letter). A files a request for and is granted an Appeals office conference. At the conference no agreement is reached on the tax matters at issue. The Internal Revenue Service then issues a notice of deficiency. Upon receiving the notice of deficiency, A discontinues A's administrative efforts and files a petition with the Tax Court. A's costs incurred in connection with the preparation and filing of a petition with the Tax Court are litigation costs and not reasonable administrative costs. Furthermore, A's costs incurred before the administrative proceeding date (date of the notice of deficiency as set forth in § 301.7430–3(c)(3)), are not reasonable administrative costs.

Example 2. Assume the same facts as in *Example 1* except that after A receives the notice of deficiency, A recontacts Appeals. Again, A's costs incurred before the administrative proceeding date, the date of the notice of deficiency as set forth in § 301.7430–3(c)(3), are not reasonable administrative costs. A's costs incurred in recontacting and working with Appeals after the issuance of the notice of deficiency, and up to and including the time of filing of the petition, are reasonable administrative costs. A's costs incurred in connection with the filing of a petition with the Tax Court are not reasonable administrative costs because those costs are litigation costs. Similarly, A's costs incurred after the filing of the petition are not reasonable administrative costs, as those are litigation costs.

[T.D. 8542, 59 FR 29363, June 7, 1994, as amended by T.D. 8725, 62 FR 39118, July 22, 1997]

§ 301.7430–5 Prevailing party.

(a) *In general.* For purposes of an award of reasonable administrative costs under section 7430 in the case of administrative proceedings commenced after July 30, 1996, a taxpayer is a prevailing party only if—

(1) The position of the Internal Revenue Service was not substantially justified;

(2) The taxpayer substantially prevails as to the amount in controversy or with respect to the most significant issue or set of issues presented; and

(3) The taxpayer satisfies the net worth and size limitations referenced in paragraph (f) of this section.

(b) *Position of the Internal Revenue Service.* The position of the Internal Revenue Service in an administrative proceeding is the position taken by the Internal Revenue Service as of the administrative proceeding date (as defined in § 301.7430–3(c)) or any date thereafter.

(c) *Substantially justified*—(1) *In general.* The position of the Internal Revenue Service is substantially justified if it has a reasonable basis in both fact and law. A significant factor in determining whether the position of the Internal Revenue Service is substantially justified as of a given date is whether, on or before that date, the taxpayer has presented all relevant information under the taxpayer's control and relevant legal arguments supporting the taxpayer's position to the appropriate Internal Revenue Service personnel. The appropriate Internal Revenue Service personnel are personnel responsible for reviewing the information or arguments, or personnel who would transfer the information or arguments in the normal course of procedure and administration to the personnel who are responsible.

(2) *Exception.* If the position of the Internal Revenue Service was substantially justified with respect to some issues in the proceeding and not substantially justified with respect to the remaining issues, any award of reasonable administrative costs to the taxpayer may be limited to only reasonable administrative costs attributable to those issues with respect to which the position of the Internal Revenue Service was not substantially justified. If the position of the Internal Revenue Service was substantially justified for only a portion of the period of the proceeding and not substantially justified for the remaining portion of the proceeding, any award of reasonable administrative costs to the taxpayer may be limited to only reasonable administrative costs attributable to that portion during which the position of the Internal Revenue Service was not substantially justified. Where an award of reasonable administrative costs is limited to that portion of the administrative proceeding during which the position of the Internal Revenue Service was not substantially justified, whether the position of the Internal Revenue Service was substantially justified is

determined as of the date any cost is incurred.

(3) *Presumption*. If the Internal Revenue Service did not follow any applicable published guidance in an administrative proceeding commenced after July 30, 1996, the position of the Internal Revenue Service, on those issues to which the guidance applies and for all periods during which the guidance was not followed, will be presumed not to be substantially justified. This presumption may be rebutted. For purposes of this paragraph (c)(3), the term applicable published guidance means final or temporary regulations, revenue rulings, revenue procedures, information releases, notices, announcements, and, if issued to the taxpayer, private letter rulings, technical advice memoranda, and determination letters (see § 601.601(d)(2) of this chapter). Also, for purposes of this paragraph (c)(3), the term administrative proceeding includes only those administrative proceedings or portions of administrative proceedings occurring on or after the administrative proceeding date as defined in § 301.7430–3(c).

(d) *Amount in controversy*. The amount in controversy shall include the amount in issue as of the administrative proceeding date as increased by any amounts subsequently placed in issue by any party. The amount in controversy is determined without increasing or reducing the amount in controversy for amounts of loss, deduction, or credit carried over from years not in issue.

(e) *Most significant issue or set of issues presented*. Where the taxpayer has not substantially prevailed with respect to the amount in controversy the taxpayer may nonetheless be a prevailing party if the taxpayer substantially prevails with respect to the most significant issue or set of issues presented. The issues presented include those raised as of the administrative proceeding date and those raised subsequently. Only in a multiple issue proceeding can a most significant issue or set of issues presented exist. However, not all multiple issue proceedings contain a most significant issue or set of issues presented. An issue or set of issues constitutes the most significant issue or set of issues presented if, despite involving a lesser dollar amount in the proceeding than the other issue or issues, it objectively represents the most significant issue or set of issues for the taxpayer or the Internal Revenue Service. This may occur because of the effect of the issue or set of issues on other transactions or other taxable years of the taxpayer or related parties.

(f) *Net worth and size limitations*—(1) *Individuals and estates*. An individual taxpayer or an estate meets the net worth and size limitations of this paragraph if, on the administrative proceeding date, the taxpayer's net worth does not exceed two million dollars. For this purpose, individuals filing a joint return shall be treated as 1 taxpayer, except in the case of a spouse relieved of liability under section 6013(e).

(2) *Others*. A taxpayer that is an owner of an unincorporated business, or any partnership, corporation, association, unit of local government, or organization (other than an organization described in paragraph (f)(3) of this section) meets the net worth and size limitations of this paragraph if, as of the administrative proceeding date—

(i) The taxpayer's net worth does not exceed seven million dollars; and

(ii) The taxpayer does not have more than 500 employees.

(3) *Special rule for charitable organizations and certain cooperatives*. An organization described in Internal Revenue Code section 501(c)(3) exempt from taxation under Internal Revenue Code section 501(a), or a cooperative association as defined in section 15(a) of the Agricultural Marketing Act, 12 U.S.C. 1141j(a) (as in effect on October 22, 1986), meets the net worth and size limitations of this paragraph if, as of the administrative proceeding date, the organization or cooperative association does not have more than 500 employees.

(g) *Determination of prevailing party*. If the final decision with respect to the tax, interest, or penalty is made at the administrative level, the determination of whether a taxpayer is a prevailing party shall be made by agreement of the parties, or absent such agreement, by the Internal Revenue Service. See § 301.7430–2(c)(7) regarding the right to appeal the decision of the Internal Revenue Service denying (in

whole or in part) a request for reasonable administrative costs to the Tax Court.

(h) *Examples*. The provisions of this section are illustrated by the following examples:

Example 1. The Internal Revenue Service, in the conduct of a correspondence examination of taxpayer A's individual income tax return, requests substantiation from A of claimed medical expenses. A does not respond to the request and the Service Center issues a notice of deficiency. After receiving the notice of deficiency, A presents sufficient information and arguments to convince a revenue agent that the notice of deficiency is incorrect and that A owes no tax. The revenue agent then closes the case showing no deficiency. Although A incurred costs after the issuance of the notice of deficiency, A is unable to recover these costs because, as of the date these costs were incurred, A had not presented relevant information under A's control and relevant legal arguments supporting A's position to the appropriate Internal Revenue Service personnel. Accordingly, the position of the Internal Revenue Service was substantially justified at the time the costs were incurred.

Example 2. In the purchase of an ongoing business, taxpayer B obtains from the previous owner of the business a covenant not to compete for a period of five years. On audit of B's individual income tax return for the year in which the business is acquired, the Internal Revenue Service challenges the basis assigned to the covenant not to compete and a deduction taken as a business expense for a seminar attended by B. Both parties agree that the covenant not to compete is amortizable over a period of five years. However, the Internal Revenue Service asserts that the proper basis of the covenant is $2X while the taxpayer asserts the basis is $4X. Thus, under the Internal Revenue Service's position, B is entitled to a deduction of two-fifths $X in the year under audit and for each of the subsequent four years. B's position, however, would result in a deduction of four-fifths $X for the year under audit and each of the subsequent four years. The deduction for the seminar attended by B was reported on the return in question in the amount of $X. The Internal Revenue Service's position is that the deduction for the seminar should be disallowed entirely. In the notice of deficiency, the Internal Revenue Service determines adjustments of two-fifths $X (the difference between the Internal Revenue Service's position of two-fifths $X and the reported four-fifths $X) regarding the basis of the covenant not to compete, and $X resulting from the disallowance of the seminar expense. Thus, of the two adjustments determined for the year under audit, that attributable to the disallowance of the seminar is larger than that attributable to the covenant not to compete. However, due to the impact on the next succeeding four years, the covenant not to compete adjustment is objectively the most significant issue to both B and the Internal Revenue Service.

Example 3. The Collection Branch of a Service Center of the Internal Revenue Service determines in the matching process of various Forms 1099 and W–2 that taxpayer C has not filed an individual income tax return. The Internal Revenue Service sends notices to C requesting that C file an income tax return. C does not file a return, so the Service Center's Collection Branch prepares a substitute for return pursuant to section 6020(b). The calculation is sent to C requesting that C either sign the return pursuant to section 6020(a) or file a tax return prepared by C. C does not respond to the Internal Revenue Service's request and the Service Center's Collection Branch issues a notice of deficiency based on information in its possession. C does not file a petition with the Tax Court and does not pay the asserted deficiency. The Internal Revenue Service then assesses the tax shown on the notice of deficiency and issues a notice and demand for tax pursuant to section 6303. After receiving notice and demand, C contacts the Collection Branch and convinces Collection to stay the collection process because C does not owe any taxes. The Collection Branch recommends that the Examination Division examine the tax liability and make an adjustment to income. The Examination Division then redetermines the tax and abates the assessment due to information and arguments presented by C at that time. The costs C incurred before the Collection Branch are incurred in connection with an action taken by the Internal Revenue Service to collect a tax. Therefore, these costs are incurred with respect to a collection action and not an administrative proceeding. Accordingly, they are not recoverable as reasonable administrative costs. Costs incurred before the Examination Division are reasonable administrative costs; however, C may not recover any reasonable administrative costs with respect to the proceeding before the Examination Division because, as of the date the costs were incurred, C had not previously presented all relevant information under C's control and all relevant legal arguments supporting C's position to the Collection Branch or Examination Division personnel (the appropriate Internal Revenue Service personnel under § 301.7430–5(c)), and thus, the position of the Internal Revenue Service was substantially justified based upon the information it had.

[T.D. 8542, 59 FR 29364, June 7, 1994, as amended by T.D. 8725, 62 FR 39119, July 22, 1997]