Refund Claim Defects and the Tax Practitioner

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In Everett Davenport et ux. v. United States, No. 5:03-cv-250-0c-10GRJ, Doc 2005-4483, 2005 TNT 46-12 (M.D. Fla. 2005), the taxpayers had filed a refund claim with the IRS on June 12, 2001, seeking a return of $31,811.50 that had been withheld from a 1999 property sale to satisfy a tax lien dating back to 1983. The Davenports argued in that claim that proceeds of earlier sales and seizures had been “impermissibly applied” to their 1983 taxes and should have “instead satisfied the 1989 liability prior to the 1999 sale.” The taxes, they said, were “impermissibly applied” to their 1983 liability because that liability had been discharged in bankruptcy.

Raising New Issues in a Refund Suit

District Judge William Terrell Hodges reviewed the arguments made by the Davenports in their refund claim and went on to point out that, over and above any flaws in those arguments, the fatal problem with their litigating situation was that:

before this Court, however, the Plaintiffs make different arguments. First, they argue that the collections statute of limitations with respect to Mrs. Davenport’s liability for the 1983 taxes had run prior to any levies or seizures of the couple’s property. . . . Secondly, the Plaintiffs argue that the IRS lien could not have attached to the property when it was reacquired in 1993 because the lien related only to Mr. Davenport and the property was held by the couple at that time as tenants by the entireties. Finally, the Plaintiffs argue that even if the tax lien properly attached to Mr. Davenport’s interest in the property at the time of the 1999 sale, the value of his interest, which they claim was the only interest subject to the lien, may be actuarially measured at less than the $31,811.50 seized.

His conclusion was that because not one of those arguments had been raised in the refund claim, and the refund claim grounds had been abandoned, “this Court lacks jurisdiction to consider the merits of the instant suit.” He granted the government’s motion seeking summary judgment.

Tax Court vs. Refund Claim Jurisdictions

Tax practitioners tend to have limited experience with refund litigation because most tax litigation goes the Tax Court route and most tax controversy gets settled without any litigation. With a few exceptions, tax practitioners have much more experience settling cases administratively or after they have been docketed with the Tax Court than in handling refund suits and the settlement of cases on which refund claims have been filed. That affects their work habits. The IRS has asserted a deficiency, and the Tax Court petition asserts that the IRS is wrong and alleges facts that, if established, would support that
conclusion. Sometimes the petition goes beyond rejecting the proposed IRS changes, of course, and asserts that the taxpayer is owed a refund.

Because most cases that get docketed with the Tax Court also get settled, and because the Tax Court is liberal in allowing pleadings to be amended if the case proceeds to trial, practitioners often see the Tax Court petition primarily as a way of keeping the settlement discussions going, albeit at a different level. Beyond that, they view the petition as a jurisdictional prerequisite -- that is, sufficient for its purpose if it will confer jurisdiction on the Tax Court over the year or the estate.

The entire year or return is what is potentially before the court. There is usually little disadvantage to not covering all possible grounds in the initial pleading. That is reassuring when the practitioner is engaged only a few days before the date the Tax Court petition must be filed. There are no extensions of time for filing the petition. Amending the petition to conform to the facts and issues that may develop may put the burden of proof on the taxpayer as to that new issue -- but what does it matter? The taxpayer generally has the burden of proof anyway. Similarly, practitioners sometimes file skimpy protests with appeals, knowing they will have an opportunity to flesh out their arguments later -- or even to raise new arguments.

The Four Corners of the Claim

A refund suit is far different from a Tax Court proceeding. The taxpayer is bringing suit on the refund claim that was filed, and it is that refund claim, and not the year, that is before the court. It isn’t enough to show that the IRS was wrong and the taxpayer has overpaid taxes. It is also necessary to establish the amount of that overpayment. The court won’t be looking at the entirety of the tax return, except in the sense that other matters not in the refund claim may be raised by the government to offset the refund being sought. As might be said about Davenport, alternative grounds for allowing the refund must be anticipated before the claim is filed. Necessary facts not available at the time of filing should be made the subject of amended or supplemental claims before final IRS action on the claim (or before the filing of suit if suit is filed after six months has passed and before IRS rejection occurs). As one appeals court said:

The IRS understood and considered the merits of Iowa 80's claim of qualification for accelerated depreciation of its asset based on the floor-space test and specifically stated as much in its letter of denial. Thus, because the IRS had sufficient notice that it was subject to a suit on this issue, we hold the doctrine of variance does not apply.

The word “variance” and the phrase “substantial variance” crop up in many contexts, such as in real estate zoning hearings. However, they have a specific and long-established meaning in the tax law when discussing court jurisdiction over a refund claim. In Lockheed Martin Corp. et al. v. United States, 80 AFTR2d 97-5918, Doc 97-23622, 97 TNT

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157-5 (Fed. Cl. 1997), Judge Diane Gilbert Weinstein described the purpose of the rule against substantial variance as it has been applied in the Court of Federal Claims by quoting from Union Pacific Railroad v. United States, 182 Ct. Cl. 103, 108, 389 F.2d 437, 442 (1968):

To prevent surprise and to give adequate notice to the [Internal Revenue] Service of the nature of the claim and the specific facts upon which it is predicated, thereby permitting an administrative investigation and determination. . . . In addition, the Commissioner is provided with an opportunity to correct any errors, and if disagreement remains, to limit the scope of any ensuing litigation to those issues which have been examined and which he is willing to defend.

Belatedly Discovered Expenditures

Lockheed Martin was attempting to amend its complaint to claim an additional $10 million of qualified research expenditure tax credits over and above the credits claimed in its refund claim. It had uncovered the additional $10 million after suit had been filed and discovery commenced. Expanding the refund amount by amending the complaint did not create a “substantial” variance from the original claim, argued Lockheed Martin, because the legal grounds of the original complaint applied equally to the newly discovered expenditures. The amendment would do nothing but change the amount at issue, so the purpose of the substantial variance rule wouldn’t be served by excluding the $10 million from consideration.

Judge Weinstein rejected the Lockheed Martin analysis. She conceded that taxpayer introduction of a different legal theory might have been involved in many, perhaps most, cases in which the government had successfully argued substantial variance. However, she noted, “The objective behind the substantial variance rule also prevents taxpayers from substantially varying the FACTUAL BASES of their claims as presented to the Service in their refund claims.” [Emphasis in original.] She saw Lockheed Martin’s additional $10 million as going beyond the factual grounds the IRS was able to review when it was considering the refund claim.

The belatedly discovered research expenditures could have provided the grounds for separate claims for refunds, she added, so they “are not factually ‘integral to nor subsidiary of’ plaintiff’s timely refund claims.” She contrasted what Lockheed Martin sought with the situation in which both the legal theory and the factual grounds remain the same, but the amount involved (such as the tax basis of a demolished building) was merely misstated. That error would be reasonably discoverable by the IRS in its consideration of the refund claim. But Lockheed Martin had not provided the IRS with details of the additional amount during the IRS audit of the refund claim. “Since plaintiff admits such expenditures were not known at the time, they necessarily were not included, in any amount,” the judge wrote.

Judge Weinstein denied the Lockheed Martin motion to amend its complaint.

Ottawa Silica
For Court of Federal Claims purposes, both Union Pacific and Ottawa Silica Co. v. United States, 669 F.2d 1124 (Fed. Cir. 1983), 95 TNT 38-279, set out the boundaries of the substantial variance rule. In Ottawa Silica, the appeals court saw the question as:

the degree to which the court will allow a taxpayer to vary the grounds of its suit from those raised in the claim for refund.

Plaintiff has alleged that the IRS failed to allow the full percentage depletion deduction that it was entitled to and, in so doing, also failed to allow plaintiff the full consolidated net operating loss deduction it was entitled to for 1967. The parties have reached an agreement that is dispositive of the substantive aspects of both the percentage depletion and the net operating loss issues. The procedural issue which remains to be resolved is whether the grounds for relief stated in plaintiff’s claim for a refund are adequate to confer jurisdiction on this court over an aspect of the percentage depletion deduction not mentioned in the refund claim.

In its refund claim, Ottawa Silica said the revenue agent who audited its returns for the years covered by the refund claim had “erroneously denied” deductions for depletion by changing the applicable percentages used for percentage depletion and had as a result improperly reduced its net operating loss carryback to 1967. When it filed the claim, the taxpayer didn’t even realize it had erred in its original calculation of the depletion deduction for a bagged product it produced called Ottawa testing sand. The refund claims were filed on or about January 7, 1975, while the mistake in the way in which depletion had been calculated on the testing sand was not even discovered by Ottawa Silica until July 1977, after the statute of limitations had run on the years involved.

The refund suit filed in 1978 as a follow-up to the refund claims then alleged that the IRS had failed to allow the taxpayer the full depletion deduction to which it was entitled. The IRS and the taxpayer, as the court noted in the quotation, had even agreed that a refund was due. The IRS, however, argued that the mere fact that the percentage depletion deductions reduced by the revenue agent’s report were subjects of the refund claim did not allow piggybacking a completely different percentage depletion question onto the lawsuit. The appeals court agreed with the IRS, explaining:

plaintiff asserts that the timely refund claim for the rate issue established its right to sue for a refund on the whole depletion issue and that the testing sand error affects only the amount plaintiff is entitled to recover. This court cannot accept plaintiff’s argument. The statute and the regulations are quite clear. A taxpayer must specify the grounds and the factual base from which they arise in its claim for a refund if it later wishes to litigate on those grounds.

**Perfecting the Claim**

It is possible, of course, to have filed an imperfect refund claim and perfect that claim with supplemental filings with the IRS even though the statute of limitations on that year has run. That is the case with “protective claims,” such as some that are now being
filed for refunds on behalf of taxpayers who in 2001 sold stock they had received in insurance company demutualization transactions. The 2001 statute of limitations for many individuals expires on April 15, 2005. Practitioners following the issue expect that pending litigation may allow taxpayers to use something more than a zero tax basis in calculating their gain on sale of that stock. See our "Life Insurance, Stock, Tax Basis, and Demutualization," Tax Notes, Aug. 4, 2003, p. 681. At the same time, the IRS has been adamant and consistent in its zero basis position since the 1970s. The amounts of possible refund for a given return are typically modest, so taxpayers may not be inclined to spend much on a protective claim. Under those circumstances, the claims prepared run the risk of being sketchy -- but they might prove sufficient if there is adequate follow-up to perfect them.

The basic rules on perfecting claims are the following, as set forth long ago in United States v. Memphis Cotton Oil Co., 288 U.S. 62 (1933), and repeated in TAM 9649005, Doc 96-31505, 96 TNT 238-19:

(1) a filed claim may be amended any time before it has been rejected by the IRS if the statute of limitations has not yet run;

(2) even if the statute of limitations has run, an amendment of the timely filed refund claim may be effective if (a) the original claim has not been rejected at the time the amendment is filed and (b) the amendment merely makes clear specific matters the IRS has already considered by investigating the original, formally defective claim; and

(3) in disputes over the effectiveness of an amendment of a timely claim made after the period for filing a refund claim has run, the IRS may be found to have waived its requirements.

In the end, however, whether a previously inadequate claim has been made sufficient in situations (2) and (3) is a facts-and-circumstances matter to which an appeals court may well apply the "clearly erroneous" standard. That means the taxpayer must persuade the trial judge that the disclosure to the IRS before the claim was rejected was sufficient to apprise the IRS of the facts and the issues.

**Administrative Claim Deadlines vs. Court Filing Deadlines**

The rule of Memphis Cotton Oil is that the filing of a general or vague claim may be sufficient to confer jurisdiction on the district court or Court of Federal Claims if the IRS had knowledge of the claim, thereby making the initial rejection of the claim for refund a determination on the merits. The statute of limitations in section 6511(b) limits the amount of tax that can be refunded on a claim filed within three years from the date the return was filed to the tax paid within the three-year period immediately preceding the filing of the claim plus the period of any extension of time that was granted for filing the return. Estimated and withholding taxes are deemed to be paid as of the return due date, meaning the statute for refunds runs

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three years from the extended due date of a timely filed return. Except for the flexibility provided by the rule of Memphis Cotton Oil and the informal claim doctrine discussed below, a court lacks the ability to make exceptions because the statute of limitations will have run if a timely refund claim wasn’t filed.

Court-imposed deadlines can be more flexible than the section 6511 statute of limitations, but judges will often allow taxpayers some leeway even on refund claims. As Appeals Judge Richard A. Posner noted in BCS Financial Corporation v. United States, 118 F.3d 522, Doc 97-18891, 97 TNT 124-15 (7th Cir. 1997):

>a technical defect in the pleading [filed with a court] that commences the suit and by doing so arrests the running of the statute of limitations is unlikely to be fatal. A complaint afflicted with merely formal defects can ordinarily be amended to correct them with relation back to the date of the original filing of this suit. Fed. R. Civ. P. 15(c); Woods v. Indiana University-Purdue University, 996 F.2d 880, 884 (7th Cir. 1993); 6A Charles Alan Wright, Arthur R. Miller & Mary Kay Kane, Federal Practice and Procedure section 1497, p. 74 (2d ed. 1990); cf. In re Wilkens, 731 F.2d 462, 464-65 (7th Cir. 1984) (per curiam).

Neither the tax code nor the Treasury regulations make any similar provision for claims for a refund. One office of the judge-made informal-claim doctrine is to plug that gap by excusing harmless noncompliance with the formalities prescribed for refund claims by the Treasury regulation. . . . Suppose that on the last day before the three years is up the taxpayer files a claim for a refund complete except for the omission of his signature. Two days later the taxpayer discovers and repairs the omission. It would be absurd rigorism even by the notably unforgiving standards of federal tax law (see, e.g., United States v. Brockamp, 117 S. Ct. 849, 852 (1997); but see Prussner v. United States, 896 F.2d 218 (7th Cir. 1990) (en banc)) to make the taxpayer’s utterly harmless mistake a basis for forfeiting a claim conceded to be substantively valid.

Conclusion

There are big differences between preparing tax returns and preparing refund claims. If the IRS disagrees with positions taken on a return, the taxpayer has ample opportunity to firm up the position both as to the facts and the theory of the case. We have taken on Tax Court cases for which we had little more to go on than the statutory notice of deficiency and a sketchy outline of the relevant facts provided by the taxpayer or the taxpayer’s return preparer. As we got into those cases, it usually turned out there was more involved, favorable and unfavorable, than we initially knew. That is manageable in a Tax Court matter. We have also sometimes gotten involved with a potential refund situation barely days before the running of the statute of limitations, and we were forced to get the claim filed without fully understanding the facts and the possible theories of the case. When that happens, it is important to perfect the refund claim as promptly as possible.

It has been easy for practitioners to get careless with refund claims in the past decade. Most claims are on X forms (1040X, 1041X,
We have observed that tax preparers preparing X forms have often provided little more specificity than if they were preparing a tax return. Those claims have routinely been allowed by the IRS in the same fashion as overpayments are allowed on originally filed returns. That isn’t an IRS practice that tax practitioners can count on for the future. The practitioner who proceeds on the assumption that preparing a refund claim is merely a variation on the normal practice in preparing a return runs the risk that someday the failure to adequately investigate the situation before preparing the claim will mean, as in Lockheed Martin and Ottawa Silica, that a client fails to get a refund that the client was entitled to. Clients unwilling to pay for that level of prefiling service should understand what is involved. That understanding should be documented for the practitioner’s own protection. Defective refund claims can invite malpractice claims from clients. We suspect that the nonlawyer practitioners whose defective refund claim preparation results in the taxpayer failing to get a refund may find a state court judge less than sympathetic, while the lawyer practitioners may find the jury expects more of them, even though the client may have been unwilling to pay for the additional service.

Since the early 1990s, thousands of false claims have been filed with the IRS for reparations credits. Promoters use a variety of techniques to market the promise of a special tax credit to African-American taxpayers, who may be descendants of slaves. Because the manual screening of tax returns by IRS employees is subject to human error and some employees may knowingly allow these illegal claims to be processed, some claims for reparations credits are processed and refunds sent to taxpayers. IRS computer controls that identify and stop reparations claims processing could be significantly improved by using a TIGTA-developed computer program. It is estimated that by using this program, IRS employees could identify 91 percent more of these returns than they could using the existing processes and stop an additional $90.7 million in refunds (revenue protection) from claims for reparations credits over a 5-year period.