

Steve Leimberg's Income Tax Planning Email Newsletter Archive Message #207

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Subject: Andrew H. Weinstein and Kevin E. Packman: Refunds -
Timing, Litigation, Mitigation and Equitable Relief

"In this newsletter, we outline various procedural issues related to claiming refunds. In the event the IRS denies the refund, we review options to litigate and mitigate the dispute relating to the refund. Finally, we focus on equitable relief and how it can be beneficial when all other doors appear to be closed."

Andrew H. Weinstein and **Kevin E. Packman** provide members with commentary that reviews various procedural issues related to claiming refunds.

Kevin E. Packman is a partner in the Miami, Florida, office of **Holland & Knight LLP**. He chairs the firm's **Offshore Compliance Team** and **International Estate Planning Group**. He is also a fellow of the American College of Trust and Estate Counsel. Kevin also serves as Technical Editor of LISI's International Tax Planning Newsletters.

Andrew H. Weinstein is a partner with **Holland & Knight LLP's Private Wealth Services Group** and the Taxation Team. Mr. Weinstein's primary focus is on representation of high-net-worth individuals, both domestic and international. Mr. Weinstein has many years of in-depth experience within the IRS and in the private sector, having acted for clients with net worth in the billions of dollars. While at the IRS, Mr. Weinstein was responsible for both federal criminal tax enforcement and civil tax disputes, including substantive examinations, collection proceedings, administrative appeals and tax litigation. In the private sector, Mr. Weinstein leverages his government experience in representing individuals, companies, trusts and estates to ensure that their international, federal, state and local tax-related planning and compliance withstands governmental review at every level. Mr. Weinstein is a Fellow of the American College of Trust and Estate Counsel and the American College of Tax Counsel and is Florida Bar Board Certified in Tax Law.

Here is their commentary:

EXECUTIVE SUMMARY:

On July 2, 2018 our newsletter titled, "Do Not Lose Your Right to Money! How to Timely Identify and File for a Tax Refund," was published as [Income Tax Planning Newsletter #146](#). That newsletter dealt primarily with refunds stemming from the foreign tax credit. In contrast, in this newsletter, we outline various procedural issues related to claiming refunds in general. In the event the IRS denies the refund, we review options to litigate and mitigate the dispute relating to the refund. Finally, we focus on equitable relief and how it can be beneficial when all other doors appear to be closed.

FACTS:

The IRS' ability to give credits or refunds is statutorily based. Section 6402. Unless there is a timely claim for refund, there is no ability to file suit seeking to collect the refund. Section 6511(b)(1); Section 7422(a). In order to claim a refund, taxpayers must comply with the applicable statute of limitation ("SOL"). Simply stated, the SOL is the later of three years from the date the return was filed or two years from the time the tax was paid. Section 6511(a). Incidentally, there are limits on the amount of the refund. Section 6511(b). Taxpayers should also consider the timeliness requirements for a State tax refund claim, which is beyond the scope of this article.

As mentioned in our prior article, it is possible to toll the SOL for assessment and refund through a Form 872. Similarly, there are numerous provisions in the Code that permit the IRS to extend the SOL for assessment purposes. These provisions may not, however, extend the SOL for refund purposes. Related thereto, the Code provides tolling on account of disability (i.e., an inability to timely submit claim). Section 6511(h). Furthermore, it is important to recognize that an extension of the SOL for assessment or refund does not impact estimated income tax payments that are treated as paid on the due date of a return without regard to any waiver. Sections 6511(c); 6513(b).

It is possible to informally claim a refund, but it is not recommended. For those inclined to follow the difficult path through life *U.S. v Kale*, 314 US 186 (1941) instructs that an informal claim must (i) be in writing, (ii) include a request for refund for a specific year, (iii) inform the IRS of the basis for

the overpayment, and (iv) provide sufficient information to allow IRS to examine the claim. Given the IRS bureaucracy, it is recommended that taxpayers simply file a claim for refund on the prescribed IRS form.

Income tax refund claims are typically made by filing a Form 1040X or Form 843. There is no comparable Form 1041X so refunds related to estate or trust income tax returns should be claimed on Form 1041. A protective estate tax claim related to administrative expenses is filed on Form 706PC. However, note that if the relevant facts are not adequately developed prior to the refund SOL, a protective refund claim should be considered to preserve the timeliness of the claim. See Karabjanian, *ACA, Unconstitutionality and the Statute of Limitations- Sorting Out The Potential Mess*, Compensation Planning Journal (BNA), Aug. 7, 2020 for further discussion on constitutional issues impacting protective claims for refund.

Earlier this year, the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act") introduced new procedures for individuals, estates, trusts, and C corporations to claim tentative refunds. Only claims allowed under sections 2303 and 2305 of the CARES Act that are made on Form 1139 or Form 1045 are eligible for these procedures. For individuals, estates and trusts, they are permitted to fax Form 1045 to 844.249.6237. C Corporations are permitted to fax Form 1139 to 844.249.6236. These procedures will terminate on December 31, 2020 at midnight.

<https://www.irs.gov/newsroom/temporary-procedures-to-fax-certain-forms-1139-and-1045-due-to-covid-19>

Refunds in excess of \$2 million (or \$5 million for a C corporation) require review by the Joint Committee on Taxation. Section 6405; IRM 34.5.2. Taxpayers may grow old before this process is completed. The IRS is required to prepare a written report to the Joint Committee for each refund that is in excess of the threshold. The report must include a factual summary on the taxpayer and the reasons for the refund. Ideally, the IRS agent will work with counsel for the taxpayer on the report to the Joint Committee.

Interestingly, the IRS is not required to comply with any requests from the Joint Committee to reconsider adjustments. However, IRS will not pay any refund until the Joint Committee staff and the IRS conclude their review of the case.

Warning: If a timely filed claim for refund is denied, there are similar SOLs applicable to filing suit. Absent an agreed extension or waiver of disallowance, a refund suit cannot be filed until six months after the claim for refund is denied. Additionally, the refund suit must be filed within two years of the date that the claim was denied. Section 6532(a). In essence, this means that taxpayers have 18 months in which to file suit unless the SOL is tolled.

COMMENT:

Refund Claim Denied - Options for Refund Suit.

Regardless as to which courts jurisdiction is sought, no refund litigation can commence in court unless a claim for refund was filed and denied.

1. U.S. District Court. Federal District Courts have jurisdiction over refund suits. 28 USC 1346(a)(1). The *Flora* rule, 357 US 145 (1960) and 362 US 145 (1960) requires full payment as a prerequisite to district court refund litigation. However, that rule does not apply to refunds involving a Section 6166 election. Section 7422(j). In the event refund litigation is commenced in district court and a notice of deficiency is issued prior to trial, the refund proceedings are stayed to allow for a U.S. Tax Court ("USTC") filing. Section 7422(e).

Be aware that the U.S. may counterclaim in district court litigation. The United States will often seek to either setoff the refund claim with additional tax due or to both setoff the refund and counter-claim for additional tax in excess of the refund. 28 USC 1346(c). Because Section 6501 provides numerous ways in which to extend the SOL for purposes of assessment, the IRS will have many options to counter-claim for additional tax due in excess of an allowed refund claim. IRM 34.5.2.4.2.2 (1). See also CCDM 34.5.1.1.2.2.1 and .2 on equitable recoupment and estoppel incident to defense letters. Since a prior timely claim for refund is a prerequisite to jurisdiction, Section 7422(a), in situations that may involve a counter-claim for additional tax due in excess of the refund claim, it may be advisable to delay filing of the refund claim until near the expiration date of the refund SOL. IRM 34.5.2.4.2.2 explains the offset process. Offsets for specific purposes are listed in the statute, Section 6402.

CCDM 34.5.1.1.2.5 explains counter-claims under Section 7401. In addition to offsets and counterclaims, consideration should be given to equitable relief in refund litigation. Such relief arises from the court's presumptive power to apply equitable principles in the absence of contrary statutory authority. See Michael T. Morley, *The Federal Equity Power*, Boston College Law Review, 59 B.C.L. Rev 217 (2018); Elliott, *Federal Tax Collections, Liens & Levies* (WG&L), par. 6.06. Finally, settlement procedures are explained in IRM 34.8.1 and the US Attorney's Manual 6-6.100 et seq. Interestingly, the procedures are substantially different from settlements in the USTC.

2. U.S. Court of Federal Claims. The U.S. Court of Federal Claims has concurrent jurisdiction with the Federal District Courts over refund suits. 28 USC 1491(a)(1). Most refund litigation, however, is not conducted in that court, but rather in the district courts. See also IRM 34.2.1.
3. USTC. Taxpayers generally prefer to file suit in the USTC on the theory that there is no requirement to pay the underlying deficiency prior to obtaining judicial review. Notwithstanding, USTC review is not possible on a refund claim unless there is also an income tax deficiency being sought by the IRS. As noted above, if a refund suit is filed in district court, and before the trial begins a notice of deficiency is issued by the IRS, then there is jurisdiction in the USTC. Refunds should be pleaded in the Petition, so as to place IRS on notice. USTC Rule 31.

If a taxpayer intends to plead equity, it should also be included in the Petition. To the extent that equitable recoupment applies as a matter of law, the USTC may determine its applicability. Section 6214(b). Equitable relief is further below explained.

SOL Barred? Pursue Equitable Options or Mitigation.

Aside from statutory mitigation below explained, the authority to make refunds or credits precludes consideration of equitable relief. Regs. 301.6402-2(b)(2). Equitable relief is nevertheless an available remedy by way of affirmative defense. See, an analysis from the Department of Justice Tax Division on how it views these equity provisions:

<https://www.justice.gov/tax/iv-offset-double-allowances-mitigation-limitations-and-equitable-recoupment>.

1. Equity

a. Equitable Recoupment. Equitable recoupment is a legal principle that is a judicially created exception to the SOL. Taxpayers should be aware that it can be used both as a sword and a weapon. Courts can apply the doctrine to grant a refund of an otherwise barred overpayment, but they may also allow IRS to use it as a means to collect (any kind of tax) from a barred year. The doctrine is premised upon preventing unfair advantage because of an expired SOL. However, there must be a fundamentally inconsistent position on the tax treatment of an item. The doctrine can only be used for the same transaction or series of transactions involved in the claim and may only be asserted to offset any damage award or deficiency judgment. It is a defense when the SOL would otherwise provide an unfair result. Different types of taxes may be offset against one another. See CCDM 34.5.1.1.2.2.1 for set-off related defenses in the context of equitable recoupment. The specific requirements are as follows:

- i. The barred overpayment or deficiency for which recoupment is sought for offset is barred by an expired SOL;
- ii. The time-barred overpayment or deficiency arose out of the same transaction, item or taxable event as the overpayment or deficiency before the court;
- iii. The transaction, item or taxable event has been inconsistently subjected to two taxes;
- iv. If the transaction, item or taxable event involves two or more taxpayers, there is sufficient identity of interest between the taxpayers such that they should be treated as one.

b. Equitable Tolling. This is essentially a no-fault concept and is premised upon a belief that a claimant should not be barred from asserting rights because of being incapable of filing a timely protective action. The government is not required to be at fault. Filing deadlines [in connection with administrative

appeals] can be tolled absent a clear contrary indication from Congress that a procedural rule is to be treated as jurisdictional.

- c. Equitable Estoppel. This is essentially a fault-based concept, unlike equitable tolling which is a no-fault concept. There are four requirements:
 - i. A false representation or wrongful misleading silence;
 - ii. The error must originate in a statement of fact, not in an opinion or statement of law;
 - iii. The one claiming the benefits of estoppel must not know the true facts; and
 - iv. That same person must be adversely affected by the acts or statements of the one against whom an estoppel is claimed.

In general, equitable estoppel requires words, acts, conduct or acquiescence causing another to believe in a certain state of things, willfulness or negligence with regard thereto and detrimental reliance.

2. Statutory Mitigation. An IRS determination is a required prerequisite for statutory mitigation. Sections 1311-1315 mitigate harsh or unfair results arising from an expired SOL. The provisions may allow a taxpayer or IRS to reopen a tax year to prevent an unfair inability to tax income or to receive a refund. While the circumstances applying statutory mitigation are more limited than for equitable recoupment, all four conditions must be satisfied:

- a. An error in a closed year that cannot otherwise be corrected by operation of law;
- b. A determination for an open year [a final decision by a court, a closing agreement, final disposition of a claim for refund, or an agreement under Reg. 1.1319(a)-4];
- c. The determination results in a circumstance under which an adjustment is authorized by Section 1312 [double inclusion or

exclusion of gross income, double allowance or disallowance of exclusion or credit, corrective deductions, credits and inclusions involving trusts, estates, beneficiaries and legatees, corrective deductions and credits for certain related corporations, and basis of property after erroneous treatment in a prior transaction]; and

- d. Except for determinations described in Section 1312(3)((B) and 1312(4), the determination must adopt a position maintained by a party that is inconsistent with the error.
3. Equitable Recoupment vs. Statutory Mitigation. Equitable recoupment requires only inconsistent treatment of a tax item. In contrast, statutory mitigation requires that the earlier time-barred treatment was erroneous. Mitigation preempts equitable recoupment, but it does not supplant recoupment. Equitable recoupment and statutory mitigation as alternatives to offset are discussed in more depth in the DOJ Settlement Reference Manual (the "DOJ Manual"), <https://www.justice.gov/tax/settlement-reference-manual-table-contents> (2015). Please note that per an email the authors received from the Executive Support Assistant to the OAG Front Office Department of Justice/Tax Division, consistent with long-standing policy, it was confirmed that the DOJ Manual reflects internal guidelines only and does not bind the Tax Division or create rights for any person.

Erroneous Refund Claims.

Section 6676 authorizes the IRS to impose a 20% penalty on refund claims that are deemed to be excessive. Interestingly, when the penalty was first enacted, it did not apply if the claim was supported by a *reasonable basis*. However, for claims filed after December 18, 2015 ("Current Standard"), the claim must be based upon *reasonable cause* to avoid the 20% penalty. There is nothing in Section 6676 or the applicable Treasury Regulations that clarifies the change from reasonable basis to reasonable cause. Prior to the amendment, IRS Counsel expressed the view that an objective test applies to Section 6676; one does not consider the taxpayer's state of mind. PMTA 2010-003. The Current Standard is a subjective test. To qualify for reasonable cause under Section 6676, the taxpayer's efforts to determine its own proper tax liability must have been reasonable. Urban, *Section 6676 Erroneous Claim for Refund Penalty*, The Tax Adviser, July 1,

2018; Verdolini and Baratta, *The Objectivity of the Reasonable Basis Defense to Tax Penalties*, Tax Notes Federal, Jan. 20, 2020, p. 391 [the reasonable basis standard is a purely objective test].

While the Section 6676 penalty is similar to the Section 6672 accuracy related penalty that is imposed on tax deficiencies, it is unclear as to whether the IRS is limited to the same SOL under both Sections. In CCA202044007, which was released on November 3, 2020, IRS Counsel stated that the Section 6676 penalty could be applied against a taxpayer who filed an income tax return claiming "a substantial amount of false withholdings resulting in an erroneous refund" more than three years after the return was filed. The final sentence in the CCA was that "[t]he claiming of the withholdings has been shown to be fraudulent." There is no analysis or discussion in the CCA as to what SOL applies to Section 6676, but it appears as though it was the fraud that permitted the penalty to be assessed more than three years after the return was filed.

Reasonable Basis Contrasted with Reasonable Cause.

The instructions to Forms 1040X and 843 point out that reasonable cause is required to avoid the penalty on a tax deficiency. The Section 6672 accuracy related penalty will not apply if there is adequate disclosure supported by a reasonable basis for the reporting position.

Clearly, a claim for refund should not be filed that is unsupported by adequate authority. Since there is no explanation as to what satisfies adequate authority, a claim for refund on which the taxpayer has a reasonable basis under an objective standard should suffice as a defense to the Section 6676 penalty.

This is contrary to the Section 6672 accuracy related penalty, which can be avoided if there was reasonable cause and the taxpayer acted in good faith. Of course, a taxpayer can also avoid the accuracy related penalty by filing Form 8275, but the factual disclosure reported on the Form 8275 must satisfy the reasonable basis standard. It is unclear if a Form 8275 is required or helpful for purposes of Section 6676. It is expected that IRS may find fault with the adequacy of any factual disclosure, whether or not reported on Form 8275, in the context of a claim for refund.

Conclusion

Subject to limited exceptions, claims for refund must be timely filed and be specific as to both facts and the amount of the refund. Refund litigation must likewise be timely filed and be consistent with the claim. Refunds in the USTC should be included in the Petition. In filing a timely claim for refund, attention should be given to estimated income tax payments without reliance on tolling. In circumstances wherein the SOL has expired, consideration should be given to any applicable exceptions relating to equitable recoupment, equitable tolling, equitable estoppel and statutory mitigation. Finally, caution should be exercised in the filing of any refund claim to ensure that it is not excessive in amount so as to trigger exposure to the penalty for excessive refund claims.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Kevin Packman

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