IRS Insights | A closer look

Taxpayer refund suit dismissed for inability to prove timely mailing of refund claim

In *Pond v. United States,*[1] the district court dismissed taxpayer's refund suit for income tax based on inability to prove timely mailing of refund claim.

Background

The taxpayer was an investor in a North Carolina limited liability company that was taxed as a partnership. In 2017, the IRS audited the partnership return for its 2012 tax year, leading the IRS to issue a Notice of Computational Adjustment ("Notice"). The Notice indicated that the taxpayer owed a balance for the 2012 tax year, which the taxpayer paid with interest.

Subsequent to paying the balance in the Notice, the taxpayer's accountants discovered that the IRS made a computational error that resulted in the IRS assessing a greater amount of tax than the taxpayer rightfully owed. As a result, the taxpayer's accountants prepared Forms 1040X, *Amended U.S. Individual Income Tax Return*, for his 2012 and 2013 tax years showing that the taxpayer was entitled to refunds for both years. The taxpayer's accountants mailed both of the amended returns in a single envelope via first-class mail to the IRS Service Center in Holtsville, New York. The envelope with both returns was purportedly postmarked with a date of July 18, 2017.

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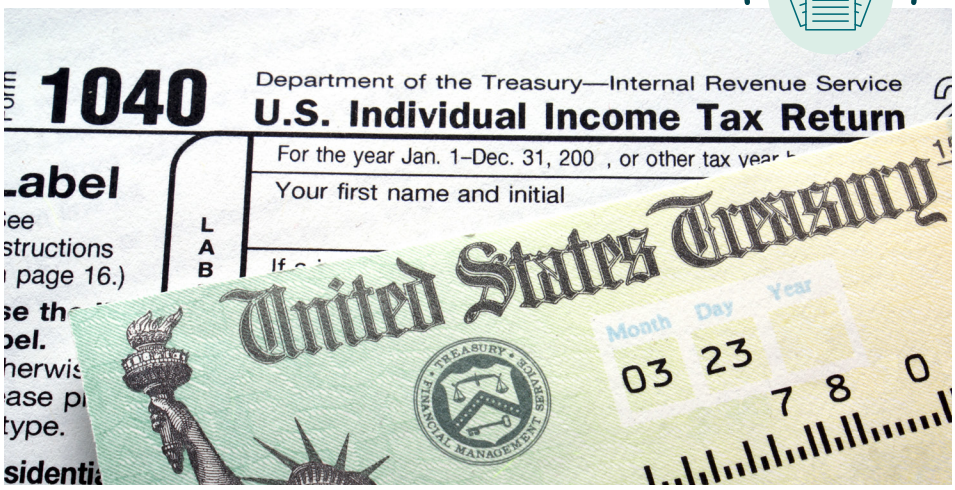
The same day, the taxpayer's accountants prepared a Form 843, ***Claim for Refund and Request for Abatement***, for recovery of the interest relating to the taxpayer's 2012 tax year and submitted it to the IRS Service Center in Covington, Kentucky. The taxpayer received a letter acknowledging receipt of the Form 843 from an IRS office in Andover, Massachusetts. The letter stated that the IRS did not have a copy of the taxpayer's 2012 amended return. The taxpayer responded explaining that the 2012 amended return had been filed with the IRS Service Center in Holtsville via first-class mail and attaching a copy of the 2012 amended return. The IRS letter or taxpayer response did not mention the 2013 amended return.

In March 2018, the taxpayer received the refund for the 2012 tax year but did not receive a refund for the 2013 tax year. The taxpayer's counsel contacted the IRS and learned that the IRS was unable to locate the 2013 amended return in its system. As a result, on February 1, 2019, the taxpayer submitted a duplicate copy of his 2013 Form 1040X to the IRS Holtsville office via certified mail, which was delivered on February 4, 2019.

Later, on July 25, 2019, the taxpayer was informed by the IRS that it had processed his 2013 amended return in March 2019; however, the IRS was unable to locate the agent working on the taxpayer's claim. The taxpayer received no further correspondence about his 2013 claim. Then on September 20, 2019, the taxpayer's counsel contacted the IRS again about the 2013 amended return and discovered that the internal case for the 2013 claim had been closed without the refund being processed. The taxpayer's counsel was further informed that IRS agents were unable to locate a copy of the 2013 amended return anywhere on the IRS's system. At the direction of an IRS employee, the taxpayer faxed a third copy of his 2013 amended return to the IRS employee. On October 1, 2019, the IRS employee denied the taxpayer's claim for refund because the applicable statute of limitation had expired. The taxpayer brought suit in district court.



Analysis

The government filed a motion to dismiss pursuant to Rule 12(b)(1) for lack of subject-matter jurisdiction based on sovereign immunity.[2] The government argued that the court lacked the ability to address the taxpayer's suit because the taxpayer could not show that his 2013 amended return was timely filed.

The United States waives sovereign immunity and grants district courts original jurisdiction for any civil actions against the United States for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected.[3] This grant of general jurisdiction is read to incorporate other requirements, including Section 7422(a) and Section 6511. Section 7422(a) requires that a plaintiff duly file a claim for refund before suing the United States.[4] This duly filed refund claim must be filed within the refund period of limitations set forth in Section 6511.[5]

For the tax years at issue (before the enactment of the BBA Partnership Regime), Section 6511(g) specified that the period of limitations for claims related to partnership items were governed by Section 6230(c) and (d), which provide that a claim for refund must be filed within six months after the day on which the Secretary mails the notice of computational adjustment to the partner.[6]

Here, the Notice was mailed out on April 26, 2017, meaning that the statutory deadline for the taxpayer's refund claim was October 26, 2017. Therefore, the applicable statutory deadline for the taxpayer's refund claim was October 26, 2017, sixth months after the notice was mailed. The court had to determine whether the taxpayer duly filed his 2013 amended return within this period.

The taxpayer argued that his 2013 amended return should be treated as timely filed under the common-law mailbox rule. The common-law mailbox rule was a traditional exception that permitted testimony and circumstance evidence to be given as proof of proper mailing.[7] This gave rise to a rebuttable presumption that the document was physically delivered. The common-law mailbox rule was crafted by courts to mitigate some of the harsh results from the physical delivery rule. Later, Congress enacted Section 7502, which provided an exception to the physical delivery rule where there was proof that the document was sent timely via registered or certified mail.[8]

The court noted that since the adoption of Section 7502, the Circuit Courts of Appeal have reached conflicting conclusions about whether the statute supplants the common-law mailbox rule.[9] The Second and Sixth Circuits held that Section 7502 provides the only exceptions to the physical delivery rule.[10] On the other hand, the Eighth and Tenth Circuits have held that Section 7502

does not provide the sole exceptions to the physical delivery and that the common-law mailbox rule still applies.[11] The Fourth Circuit, which is controlling for this district court, has yet to rule on the issue.

In deciding the question, the district court looked to the Treasury Regulations under Section 7502 ("Regulations"), which were amended as a result of this circuit split. The Regulations provide that proof that mail was registered or postmarked via certified mail is the exclusive means to establish *prima facie* evidence of delivery of a document.[12] The taxpayer argued that the Regulations misconstrued the statute and, therefore, he could still rely on the common-law mailbox rule to establish that he timely filed his 2013 amended return.

The court applied a ***Chevron***[13] analysis to determine whether to defer the agency's interpretation. The Chevron analysis is a two-step inquiry that first requires the court to first examine whether Congress has directly spoken to the precise question at issue. If Congress's intent is clear, then that is the end of the matter, and the court must give effect to the unambiguously expressed intent of Congress. However, if Congress has not directly addressed the precise question at issue, the court does not impose its own construction, but rather, the court looks to see if the agency's regulatory interpretation is a permissible construction of the statute.[14]

The court looked to the Ninth Circuit's ***Chevron*** analysis of the Regulation for guidance.[15] The Ninth Circuit found that Section 7502 was silent on the issue of whether the statute supplants the common-law mailbox rule.[16] The Ninth Circuit then proceeded to step two of the analysis and found that the Regulation was a permissible construction of the statute. The district court found this analysis persuasive and thus found that the taxpayer could not establish proof of delivery through the common-law mailbox rule.

Conclusion

That left the only available avenue for relief for the taxpayer was to show actual physical delivery or proof of mailing by certified/registered mail. The taxpayer could not do so, and the court ordered the dismissal of the taxpayer's suit. This case is a useful reminder that taxpayers should ensure that the mailing of any refund claims to the IRS be in accordance with the procedures in the Regulations and that proof of timely filing is maintained.

IRS did not satisfy the APA notice-and-comment procedures in promulgating a listed transaction

In *Mann Construction, Inc. v. United States,*[17] the United States Court of Appeals for the Sixth Circuit held that the procedure used by the IRS to identify a transaction as a listed transaction violated the Administrative Procedure Act (APA).

Background

The case centered on a dispute between taxpayers and the IRS over Notice 2007-83, *Abusive Trust Arrangements Utilizing Cash Value Life Insurance Policies Purportedly to Provide Welfare Benefits,* which required taxpayers to disclose their participation in transactions involving cash-value life insurance policies connected to employee-benefit plans to the IRS.[18] Mann Construction (Company) and its owners established an employee-benefit trust that paid a cash-value life insurance policy benefitting the owners. The Company deducted the premiums, and the owners reported as the income part of the insurance policy's value. Neither the Company nor owners disclosed their participation to the IRS.

The IRS determined that the employee-benefit plan in which Mann Construction and its owners participated was a transaction identified as a "listed transaction" in Notice 2007-83.[19] The IRS assessed Section 6707A[20] penalties against Mann Construction and its owners for not disclosing their participation in a listed transaction.[21] After paying the assessed penalties, the taxpayers filed refund claims, arguing that this disclosure requirement was invalid because the IRS failed to meet the APA's notice-and-comment requirements when promulgating a legislative rule, and therefore it constituted unauthorized agency action. The district court upheld the disclosure requirement as it found that Congress exempted the IRS from the APA's requirements with respect to these disclosure rules. The case was appealed to the Sixth Circuit.

Analysis

While the taxpayer raised multiple arguments on appeal, the Sixth Circuit focused on the taxpayer's argument that Notice 2007-83 failed to comply with the notice-and-comment requirements of the APA. While the IRS admitted that it did not follow the notice-and-comment procedure when it issued Notice 2007-83, the government argued that: (i) Notice 2007-83 is an interpretive rule exempt from the notice-and-comment procedure; and (ii) even if Notice 2007-83 is a legislative rule, Congress exempted the IRS from complying with the notice-and-comment procedure in the statute.

The Sixth Circuit examined whether Notice 2007-83 is a legislative rule. Only binding substantive agency rules must satisfy the required notice-and-comment procedures.[22] Legislative rules have the "force and effect of law"; interpretive rules do not.[23] Legislative rules impose new rights or duties and change the legal status of regulated parties; whereas interpretive rules articulate what an agency thinks a statute means.[24] On this basis, the Sixth Circuit concluded that Notice 2007-83 amounts to a legislative rule as it has the force and effect of law, imposing a duty on taxpayers to disclose listed transactions to the IRS. The IRS argued that Notice 2007-83 was merely an interpretation of the term "tax avoidance transaction" in the statute adopted by Congress. The Sixth Circuit rejected this argument by noting that the rule created new substantive duties and imposed penalties for violations.

Next, the Sixth Circuit turned to the IRS's argument that Congress expressly exempted the IRS from APA notice-and-comment requirements as part of the efforts to combat tax shelters. Before an agency may regulate without complying with the APA's notice-and-comment requirement, it must show that Congress "expressly" carved out an exception.[25] The Sixth Circuit observed that while Congress does not need to employ magic words to effectuate an exemption from the APA, there must be an express indication of congressional intent.[26] The Sixth Circuit found that this case falls on the failure-to-be-expressed side of the line as Section 6707A does not contain language exempting the IRS from the strictures of the APA, and Congress did not expressly displace the APA by devising new procedures for identifying listed and reportable transactions. Instead, the statute merely established a disclosure and penalty regime for the IRS to administer.

The IRS argued that Congress waived the APA requirement by pointing to the definition of reportable transaction in the statute, which defines such transactions as those determined under the regulations prescribed under Section 6011. The regulations under Section 6011 allowed the IRS to identify reportable transactions by notice, regulation, or other form of published guidance.[27] The IRS argued that this cross-reference by Congress amounted to a waiver. The Sixth Circuit rejected this argument finding that a tacit acknowledgment was insufficient evidence of an express waiver. The Court held that potential inferences layered on top of conjectural implications do not suffice.

Conclusion

On these grounds, the Sixth Circuit ruled that the IRS process for issuing Notice 2007-83 did not satisfy the APA's notice-and-comment procedures and reversed the district court.

The APA saga continues

A district court has ruled that an IRS notice is invalid because (1) the IRS did not follow the APA's notice-and-comment procedures and (2) the notice is arbitrary and capricious.[28]

Background

In 2016, the IRS issued Notice 2016-66, which listed certain micro-captive transactions as "reportable transactions." The issuance of Notice 2016-66 ("Notice") triggered reporting obligations for taxpayers and certain advisers who either participated in or were material advisers with respect to the transactions.[29] If a taxpayer or adviser fails to comply with the reporting obligations, it is subject to potential civil and criminal penalties.[30]

The adviser, CIC Services, filed a lawsuit to invalidate Notice 2016-66 and to bar the IRS from imposing the reporting obligation on micro-captive transactions. CIC Services argued the Notice violated the Administrative Procedure Act (APA) because the Notice imposed a regulatory requirement without the benefit of notice and comment. The government argued that the lawsuit had to be dismissed under the Anti-Injunction Act, which bars taxpayers from bringing suits to enjoin the IRS from assessing and collecting taxes.

The case went all the way to the Supreme Court. A unanimous Supreme Court ruled that the Anti-Injunction Act did not apply because CIC Services was not seeking to enjoin the IRS from collecting or assessing a tax, but simply seeking to enjoin the IRS from enforcing a reporting obligation.[31] After the Supreme Court decided that CIC Services' challenge to Notice 2016-66 could go forward, the case was remanded back to the district court to determine whether the Notice was invalid under the APA.

Court's ruling

On summary judgment, CIC Services argued Notice 2016-66 was invalid because (1) the IRS did not comply with the APA's notice-and-comment procedures and (2) the Notice was arbitrary and capricious. The district court agreed.

Notice-and-comment procedure

The IRS conceded that it did not engage in the APA's notice-and-comment procedures before issuing Notice 2016-66 but asserted that it was not required to do so. First, the IRS argued that Congress exempted the IRS from the APA's notice-and-comment procedures and second, even if the IRS was subject to APA, Notice 2016-66 was an interpretative rule, which does not require notice and comment.

The district court summarily rejected the IRS's arguments based on the Sixth Circuit's ruling in *Mann Construction*, which involved a similar notice to Notice 2016-66. The IRS raised the same arguments in *Mann* (i.e., exempt from APA, interpretative ruling). The Sixth Circuit ruled that the notice in that case was a legislative rule and Congress did not exempt the IRS from complying with the APA's notice-and-comment procedures. Because the CIC Services case is appealable to the Sixth Circuit, the district court said it was bound by the *Mann* decision.

Arbitrary and capricious

Under the APA, a court must "hold unlawful and set aside" any agency action that is arbitrary and capricious.[32] To determine whether an agency's action was arbitrary and capricious, courts consider whether the agency examined the "relevant data" and articulated a "satisfactory explanation" for its decision, including a rational connection between the facts found and the choice made.[33]

The court concluded the IRS's issuance of Notice 2016-66 was arbitrary and capricious because (1) the administrative record did not include any relevant data and facts supporting the IRS's decisions in Notice 2016-66, (2) the Notice simply says the IRS is "aware" of the transaction and "believes" the transaction has potential for tax avoidance, and (3) the Notice does not identify any facts or data supporting its belief.

Conclusion

Based on the above, the court invalidated Notice 2016-66. The court rejected the IRS's request to leave the Notice in place while the IRS promulgated a new or amended rule. The court said nothing supported leaving the Notice in place especially because the IRS "does not have a great history of complying with APA procedures."[34]

Taxpayers owe penalties despite reliance on CPA's incorrect advice

In *Oosterwijk v. United States,*[35] the Oosterwijks requested a refund of failure-to-file and failure-to-pay penalties based on reasonable cause attributable to their reliance on their CPA to timely file the extension request and the CPA's incorrect advice about halting penalties. The district court ruled the taxpayers lacked reasonable cause and upheld the penalties.

Background

The Oosterwijks used their longtime CPA to prepare their 2017 federal income tax return. The CPA told the Oosterwijks he would prepare and e-file a Form 4868, *Application for Automatic Extension of Time to File U.S. Income Tax Return* and that filing the Form 4868 would trigger an automatic debit from their bank account of $1.8 million (the tax balance due).

On April 30, 2018, the CPA discovered he did not e-file the Form 4868. The CPA told the Oosterwijks if they paper filed a Form 4868, they would have until October 15, 2018, to file their tax return and the late filing penalties would stop accruing. The Oosterwijks immediately mailed to the IRS a Form 4868 and a check for $1.8 million. The IRS posted the payment to the Oosterwijks' 2017 Form 1040 account on May 4, 2018. The Oosterwijks e-filed their 2017 Form 1040 on June 29, 2018.

The IRS assessed failure-to-file and failure-to-pay penalties under Section 6651(a). The failure-to-pay penalty ran from April 17, 2017 (due date for 2017 Form 1040) to May 4, 2018 (date payment posted). The failure-to-file penalty ran from April 17, 2017, to June 29, 2018 (when the Oosterwijks filed their return). The penalties totaled almost $275,000; almost all of it was due to the failure-to-file penalty.

The Oosterwijks informally requested penalty relief in November 2018.[36] The IRS Appeals offer agreed to abate half of

the penalties (approximately $137,000). The Oosterwijks filed a Form 843, *Claim for Refund and Request for Abatement,* for the remaining amount. When the IRS did not act on the claim after six months, the Oosterwijks filed a refund suit in district court. The government moved to dismiss the case.

Analysis

Section 6551(a) imposes penalties on taxpayers who fail to timely file their tax returns and pay their taxes. The penalties are not imposed if the failure to file was attributable to reasonable cause.[37] The Oosterwijks argued two separate bases for reasonable cause.

Reasonable cause due to CPA's failure to e-file

First, the Oosterwijks argued that they had reasonable cause for the entire amount of the penalties because their CPA failed to e-file the extension request. The Supreme Court already ruled in ***United States v. Boyle***[38] that a taxpayer cannot reasonably rely on its tax adviser to file its tax return. However, the Oosterwijks argued that ***Boyle*** does not apply to electronic filings.

The Oosterwijks argued that e-filing interposes a third party between the taxpayer and the IRS, and their inability to e-file on their own or to confirm the e-filing's transmission put the filing beyond their control. The district court disagreed. The court said the Oosterwijks could have (and ultimately did) paper filed the extension request, and e-filing did not put the filing out of their "control" in a way contemplated by the Supreme Court (e.g., physical or mental incapacity).[39] The court acknowledged that the IRS "clearly prefers and promotes e-filing," but that fact did not appear to influence the court. Although the court did say its analysis might change "in a world of mandatory e-filing."[40]

Reasonable cause based on CPA's bad advice

Second, the Oosterwijks argued they did not owe the failure-to-file penalty that accrued after April 30, 2018—the date their CPA incorrectly advised them that they could stop penalties from accruing by filing the extension request. The Oosterwijks said they would have immediately filed their Form 1040 rather than waiting until June 2018, if they had known the extension request would not stop the penalties from accruing.

The government argued the taxpayers' reasonable reliance defense failed because (1) the late filing penalty is indivisible and there is no reasonable cause exception for the accrual of a late filing penalty once it has been applied, and (2) the Oosterwijks could not reasonably rely on the CPA's bad advice when the instructions for the extension request explicitly contradicted the CPA's bad advice.

The district court said that "although the penalty is not entirely indivisible for the

purposes of the reasonable cause exception, it is not divisible in the way the Oosterwijks hope."[41] The cases where the penalty is divisible involve situations where the taxpayer had reasonable cause on the date of the failure to file, but then circumstances change to remove the reasonable cause.[42] Because the Oosterwijks did not have reasonable cause when the tax return was due, the court said the failure to file was not due to reasonable cause, and the Oosterwijks were liable for the failure-to-file penalty.

The court also stated that even if the failure-to-file penalty was divisible, the Oosterwijks could not have reasonably relied on their advice that filing a late extension request would halt the accrual of the penalties. The court concluded it was unreasonable for the Oosterwijks to rely on the CPA's advice that an untimely extension request would halt penalties when the instructions for the request explicitly state it must be filed before the due date for the return.

Conclusion

Based on the above, the court upheld the penalties even though it was "sympathetic" to the Oosterwijks.[43] It is likely that other taxpayers will continue to raise the e-filing argument in other venues.[44]

Endnotes

1 Pond v. United States, No. 1:21CV83, 2022 U.S. Dist. LEXIS 68542 (M.D.N.C. Apr. 13, 2022).

2 See Fed. R. Civ. P. 12(b)(1).

3 28 U.S.C. § 1346(a)(1).

4 I.R.C. § 7422(a).

5 I.R.C. § 6511.

6 I.R.C. §§ 6511(g) and 6230(c)(2)(A).

7 Baldwin v. United States, 921 F.3d 836, 840 (9th Cir. 2019).

8 I.R.C. § 7502(a), (c).

9 See Sorrentino v. IRS, 383 F.3d 1187, 1191 (10th Cir. 2004).

10 See Deutsch v. Comm'r, 599 F.2d 44, 46 (2d Cir. 1979).

11 See Estate of Wood v. Comm'r., 909 F.2d 1155, 1162 (8th Cir. 1990); Sorrentino, 383 F.3d 1187 at 1193.

12 See Treas. Reg. § 301.7502-1(e).

13 Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 842 (1984).

14 Id. at 843.

15 See Baldwin, 921 F.3d at 842–43.

16 Id. at 842.

17 Mann Constr., Inc. v. United States, No. 21-1500 (6th Cir. Mar. 3, 2022).

18 See Notice 2007-83, 2007-2 C.B. 960.

19 Treas. Reg. 1.6011-4(b)(2) defines a listed transaction as "a transaction that is the same as or substantially similar to one of the types of transactions that the Internal Revenue Service (IRS) has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction."

20 26 U.S.C. § 6707A

21 Taxpayers are required to disclose their participation in reportable transactions by: (i) attaching a Form 8886, Reportable Transaction Disclosure Statement, to their tax return; and (ii) sending a copy of the Form 8886 to the Office of Tax Shelter Analysis (OTSA). See Treas. Reg. 1.6011-4(d) and Treas. Reg. 1.6011-4(e).

22 Chrysler Corp. v. Brown, 441 U.S. 281, 295 (1979).

23 Perez v. Mortg. Bankers Ass'n, 575 U.S. 92, 96-97, (2015).

24 Tenn. Hosp. Ass'n v. Azar, 908 F.3d 1029, 1042 (6th Cir. 2018).

25 5 U.S.C. § 559.

26 Marcello v. Bonds, 349 U.S. 302, 310, (1955).

27 Treas. Reg. 1.6011-4(b)(1)-(2).

28 CIC Servs., LLC v. IRS, No. 3:17-cv-110, 2022 U.S. Dist. LEXIS 63545, at *1 (E.D. Tenn. Mar. 21, 2022).

29 See I.R.C. § 6011(a); Treas. Reg. §§ 1.6011-4, 301.6111-3, 301.6112-1.

30 See e.g., I.R.C. § 6707A.

31 CIC Servs., LLC v. IRS, 141 S. Ct. 1582, 1592 (2021).

32 7 U.S.C. § 706(2)(A).

33 CIC Servs., LLC v. IRS, No. 3:17-cv-110, 2022 U.S. Dist. LEXIS 63545, at *12 (E.D. Tenn. Mar. 21, 2022) quoting Dep't of Com. v. New York, 139 S. Ct. 2551, 2569 (2019).

34 CIC Servs., LLC v. IRS, 925 F.3d 247, 258 (6th Cir. 2019).

35 2022 U.S. Dist. Lexis 14984 (Jan. 27, 2022).

36 The Oosterwijks did not qualify for the IRS's First Time Abatement program because they had a $7 failure-to-pay penalty in 2014.

37 See Section 6651(a)(1), (2) (penalties not imposed when "it is shown that such failure is due to reasonable cause and not due to willful neglect....").

38 United States v. Boyle, 469 U.S. 241 (1985).

39 See Boyle, 469 U.S. at 253 (Brennan J., concurring) (stating the reasonable cause standard differs for individuals with disabilities or infirmities that render them physically or mentally incapable of knowing, remembering, and complying with a filing deadline).

40 Oosterwijk, 2022 U.S. Dist. Lexis 14984 at *17 citing Intress v. United States, 404 F. Supp. 3d 1174, 1183 (M.D. Tenn. 2019) ("It appears that at least until e-filing is universally mandatory, or paper filing becomes sufficiently unwieldy, Boyle will continue to apply.")

41 Id., at *25.

42 E.g. Estate of Liftin v. United States, 111 Fed. Cl. 13, 23 (holding taxpayer had reasonable cause at date of filing based on erroneous advice to wait to file until spouse became a naturalized citizen, but lost reasonable cause when spouse became citizen but didn't file for another several months).

43 The court also considered the government's argument that the Oosterwijks' case must be dismissed because the arguments they were raising in the case "substantially varied" from the arguments they raised in their Form 843 refund claim. However, the court concluded the statements in the Form 843 were sufficient to apprise the IRS of the taxpayers' reasonable cause arguments.

44 See Intress, 404 F. Supp. 3d 1174 (M.D. Tenn. 2019) (rejecting taxpayer's reasonable argument that Boyle is inapplicable because of e-filing); Haynes v. United States, 760 F. App'x 324, 326 (5th Cir. 2019) (identifying question of whether Boyle applies to e-filling as unresolved but declining to address it).