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News Analysis: Did the Federal Circuit Just Issue Another Murphy?

by Jeremiah Coder

Summary by taxanalysts

In news analysis, Jeremiah Coder examines the criticism of a recent Federal Circuit ruling that created a new "harmless error" rule for some refund cases.

Full Text Published by taxanalysts

When an appellate court is universally denounced for its legal reasoning, a hasty retreat and a withdrawn opinion usually follow. Everyone remembers the D.C. Circuit's original opinion in *Marrita Murphy v. IRS*, holding that it was unconstitutional for the IRS to tax nonphysical compensatory damages. After that decision received extensive criticism, the court eventually reversed itself and found that the damage award was not excludable from income. *Xilinx Inc. v. Commissioner* is another example of a court reversing after facing strong criticism.

The Federal Circuit may have added to the pantheon of tax decisions with a limited shelf life. Admittedly, the 1982 Tax Equity and Fiscal Responsibility Act is an area few have mastered because of the complexity involved, so judges with no special tax expertise might be expected to get details of the regime wrong now and then. But the problem explored here has less to do with the court's analysis of TEFRA than it does with the creation of a "harmless error" rule that has no apparent place in the statutory construction of the tax code.

In *Bush v. United States*, the taxpayer and his deceased wife were one of several partners in a 1980s purported tax shelter. The Bushes' participation in the partnership proceeding in Tax Court ended after they settled with the IRS and signed a closing agreement that made no changes to the reporting of partnership items. The IRS then made an assessment against the taxpayers for several years covered by the closing agreement based on the Bushes' at-risk capital amounts, but it never issued them a notice of deficiency. The taxpayers paid the tax liabilities and sued for a refund in the Court of Federal Claims.

Central to the case was whether the IRS was required to give the Bushes a notice of deficiency. Although the general rule is that it would be, section 6230(a)(1) exempts computational adjustments from the notification requirement unless the adjustment relates to affected items.

In deciding the parties' cross-motions for partial summary judgment, the Court of Federal Claims held that the IRS's adjustments were computational because the assessed liabilities were determined based on the closing agreement and taxpayers' individual returns, and thus no deficiency notice was required. The case was one of two selected to serve as test cases for the rest of the similarly situated partnership plaintiffs seeking refunds. (For *Lyman F. Bush et al. v. United States*, No. 02-1041T (Ct. Fed. Cl. Aug. 17, 2007), see *Doc 2007-19230* or *2007 TNT 162-9*.)

On appeal, a majority of the Federal Circuit panel concluded that notice was required "because the assessments did not meet the definition of 'computational adjustment [s]' under section 6231(a)(6)." The closing agreement made no changes to any partnership items, so there was no change in treatment that would trigger the computational adjustment exclusion to notice, according to the Court. (For *Lyman F. Bush et al. v. United States*, No. 2009-5008 (Fed. Cir. Mar. 31, 2010), see *Doc 2010-7106* or *2010 TNT 62-8*.)

At-risk amounts are partner-level items requiring separate determinations, the court said. Reg. section 301.6231(a)(6)-1T(a) did not apply because it was illogical to think that "all affected items that do not require partner-level determinations are exempt from deficiency proceedings," the court said, adding that the "statutory language is quite clear."

But the court then took a strange turn by holding that even if notice was required, "the IRS's failure to issue a notice of deficiency constituted harmless error under the circumstances of this case." The court said that although most collection circumstances require the IRS to provide notice -- the general absence of which "is both unauthorized and wrongful" -- the taxpayers' unusual refund position created by paying the assessment before collection was sought took the situation outside the scope of the normal deficiency rules. No automatic refund was contemplated by section 6213, the majority said, so the lack of notice was not prejudicial to the taxpayers.

Harmless Error Rule

The court looked outside the tax code to 28 U.S.C. 2111 as authority to introduce its newly created harmless error rule in some refund cases. Because the taxpayers did not show that "substantial rights were affected because they were denied access to the Tax Court to raise their offset claims," the IRS was excused from its notice responsibilities, the court said. The majority relied on the assumption that the Bushes would not have faced a different outcome if they were able to bring suit in the Tax Court. Also, under the collection due process procedures implemented after the Internal Revenue Service Restructuring and Reform Act of 1998, taxpayers can contest collection actions begun without appropriate notice in the Tax Court, the majority said.

Although the court tried to imply that the harmless error rule it drafted should be applied only in limited situations, it is hard to reconcile the court's statement of narrow application after the fact. The court is asking for trouble.

In a concurring opinion, Judge Sharon Prost agreed with the result but excoriated the majority's legal analysis. Calling the case "abstract and unapproachable," she said a clear reading of the statute supported the lower court's interpretation that the IRS's adjustments were computational because they made changes to the taxpayers' tax liability without necessarily relating to their partnership items.

More troubling to Judge Prost, however, was what she called the majority's "legally unsound and practically harmful" rule. Nullifying taxpayers' right to notice -- which she described as a "categorical, nonnegotiable notice requirement, denial of which can never be harmless" -- would lead to depriving them of a forum to contest IRS action because notice is a prerequisite to filing in Tax Court, she said.

Caught by Surprise

Because neither party explicitly advocated or briefed the possibility of a harmless error rule, the court's *sua sponte* nonstatutory exception has caught many in the tax bar by surprise. One tax practitioner told Tax Analysts that the circuit panel majority was violating the separation of powers in "whiting out deficiency procedures" with the harmless error rule. "The court is possibly coming to the right answer but ignoring clear statutory provisions of the code in the process," the practitioner said.

Stuart J. Bassin of Baker and Hostetler LLP said that Judge Prost's concurring opinion was right to strongly object to the new, sweeping harmless error rule. "Most tax practitioners always thought that issuing notices and [final partnership administrative adjustments], and the effect it had on a court's jurisdiction, were black letter rules. If you failed to satisfy the rules, the result was a jurisdictional flaw that could not be fixed," he said. "The ruling raises interesting questions for all taxpayers who have had their cases dismissed because they tried to litigate nonpartnership items in a partnership proceeding, and vice versa."

TEFRA procedures have created an enormous amount of litigation, and the differences between the majority and concurring opinions in defining and applying the computational procedures to nonpartnership items show how unclear the area is, Bassin said. "It's a concept that is easy to apply in easy cases, but reasonable minds can differ on a number of issues in this area," he said, adding that regardless of the analysis used, "the case is further evidence of why the whole TEFRA regime should be reconsidered."

While the circuit court's opinion creates a release valve allowing for the dismissal of refund cases in which no deficiency notice was given, the manner in which that release valve was created is not legally sound, Bassin said. "The ruling is useful in the sense that it limits the number of people who never get to the merits of a tax controversy because of a jurisdictional challenge, but there is absolutely no grounds for a harmless error rule regarding jurisdiction," he said.

Bassin said it will be interesting to see whether the IRS embraces the harmless error rule since it was not explicitly asked for in government briefs. "The rule saved the day here for the IRS, but it could pose a big problem in other cases," he said. If the taxpayer seeks a rehearing, it is possible that the government will not defend the majority opinion, he said.

Asked about the chances of *en banc* review by the Federal Circuit, Bassin said it was unlikely, noting the rarity of such reconsiderations in tax cases.

Another practitioner who spoke to Tax Analysts on the condition of anonymity said the majority opinion was right in concluding that there was no computational adjustment. "The closing agreement short-circuited the TEFRA process, which is a common occurrence because no one wants to deal with the complexity," the practitioner said, adding that the IRS's mistake in the case was forgetting to include a procedure in the agreement to translate the substantive decisions therein to tax adjustments. "Consequently, the IRS should have issued a notice of deficiency since it didn't do the closing agreement right," the practitioner said.

But regarding the majority's no-prejudice analysis, the practitioner asked, "How can violation of the deficiency notice requirement not be harmful?" The cases relied on in the opinion to support the harmless error ruling were misconstrued because the only reason no harm occurred in each instance was because the taxpayer went to the Tax Court, the practitioner added.

"I'm not sure the IRS can live with this opinion even though it came out the victor," the practitioner said.

Going Too Far

Bryan Camp, the George H. Mahon Professor of Law at Texas Tech University School of Law, said the right statutory interpretation wasn't necessarily that clear. However, even if the majority was right as to whether a deficiency notice was required, it went too far on the second question of prejudicial effect, he said. "There is no harmless error exception for an invalid assessment," he said. "I agree with all Judge Prost says in her concurrence on that subject."

Camp said he believed the best legal rationale for a decision in the case went unmentioned. "I think a court could find for the Service without needing to reach the assessment question," he said. Because the case involved a refund, "it doesn't really matter whether the assessment was valid," he said. "That is because in a refund suit, the issue is only whether taxpayers overpaid their tax liabilities."

Under Supreme Court precedent, taxpayers bear the burden of proving overpayment of taxes, Camp said. (See *Lewis v. Reynolds*, 284 U.S. 281 (1932).) "The IRS may have missed an opportunity to further reiterate this position," he said. "If the majority was right that the assessment was invalid for want of a notice of deficiency, the Service can still keep any monies paid before the expiration of the period of limitation for assessment, so long as those payments are not more than the taxpayer's tax liability when the payments were made." (For prior analysis by Camp, see *Tax Notes*, Aug. 20, 2007, p. 687, *Doc 2007-18071*, or *2007 TNT 162-30*.)

Camp said the IRS should disregard the majority decision's legal rationale in other cases. "I would hope the Service would issue an [action on decision] rejecting the harmless error rationale and instead explain the correct basis for its victory," he said.

Indeed, the government's formal response to the *Bush* decision will be interesting. Practitioners are warning that although the case resulted in a favorable outcome for the IRS, the new rule could cause it considerable difficulty down the road. As in *Murphy*, the court designed a remedy inconsistent with established precedent. If history is any guide, the ruling may not survive for long.

Tax Analysts Information

Code Sections: Section 6230 -- Partnership Administrative Changes
Section 6231 -- Partnership Item Definitions
Section 6213 -- Deficiencies, Tax Court Petitions
Jurisdiction: United States