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Matthew J. Barrett

Notre Dame Law School, matthew.j.barrett.1@nd.edu

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Can a Deficiency Notice to a Non-Filing Taxpayer Shorten the Time to Claim a Refund in the Tax Court?

by Matthew J. Barrett

Case at a Glance

Matthew J. Barrett is associate professor of law at Notre Dame Law School, Notre Dame, IN; (219) 631-8121.

ISSUE

Does the Internal Revenue Code prevent a taxpayer from obtaining a tax refund in the Tax Court when the Commissioner of Internal Revenue issues a notice of deficiency more than two years after the taxpayer's return should have been filed and before the taxpayer actually files a return?

FACTS

This case concerns the 1987 federal income tax liability of Robert F. Lundy, a retired government economist from Lorton, Virginia. During 1987, Lundy's employer withheld \$10,131.11 in federal income taxes from his wages. For a number of reasons, including health problems, a car accident that required hospitalization, family problems, and a divorce, Lundy did not timely file a 1987 federal income tax return.

On September 26, 1990, more than two years after the due date for Lundy's 1987 return, the Commissioner of Internal Revenue (the "Commissioner") mailed a statutory notice of deficiency. The notice asserted that Lundy owed an additional \$13,806 in income taxes for 1987.

About three months later, on December 22, 1990, Lundy and his wife mailed a joint income tax return for 1987. The late return claimed a \$3,537 tax overpayment. On December 28, 1990, Lundy filed a petition in the Tax Court contesting the notice of deficiency. Lundy also sought a determination from the Tax Court that he had overpaid \$3,537 in 1987 federal income taxes.

While Lundy's case was pending, the Internal Revenue Service (the "Service" or the "IRS") was reviewing his untimely return and information Lundy later provided to support deductions taken on the return. After completing its review, the Service sent Lundy a letter stating that he and his wife would receive a refund for 1987.

Back in the Tax Court, the Commissioner filed a motion to amend her answer and raised, for the first time, the defense that the time limitations for seeking a refund barred Lundy's claim. The Commissioner's amended answer

(Continued on Page 69)

Each year, about three million people overpay their federal income taxes but don't file returns. Taxpayers usually have three years to claim a refund. When a non-filer waits more than two years before seeking a refund, the IRS often seeks more tax because the taxpayer has not filed. If the taxpayer appeals to the Tax Court to avoid paying the additional tax, the IRS says the refund period is only two years. Now the Supreme Court decides if a deficiency notice can shorten the time to claim a refund in the Tax Court.

COMMISSIONER OF INTERNAL
REVENUE V. ROBERT F. LUNDY
DOCKET No. 94-1785

ARGUMENT DATE:
NOVEMBER 6, 1995
FROM: THE FOURTH CIRCUIT





acknowledged that Lundy did not owe any additional taxes for 1987 and that he had actually overpaid his tax liability for that year.

Following various stipulations that established an overpayment of \$2,390.11, the only issue in the Tax Court became whether or not Lundy qualified for a refund. The Tax Court ruled that Lundy had overpaid his 1987 federal income taxes but that the Commissioner did not have to refund the overpayment because the applicable statute of limitations had expired. 65 T.C.M. (CCH) 3011 (1993).

Statutes of limitations prevent taxpayers from raising stale claims. The Tax Court concluded that the statute of limitations for refund claims required it to consider the facts as they existed on the date the Commissioner mailed the notice of deficiency. Noting that Lundy had not filed a tax return on the mailing date, the Tax Court applied a two-year "look-back" period. Because Lundy paid his 1987 taxes more than two years before the Commissioner mailed the notice of deficiency on September 26, 1990, the Tax Court concluded that Lundy did not qualify for a refund. (Under 26 U.S.C. § 6513(b)(1) (1988), income taxes withheld for a given year are deemed paid on April 15 of the following year. Thus, Lundy's 1987 incomes taxes were deemed paid on April 15, 1988.)

Lundy appealed to the Fourth Circuit which reversed. 45 F.3d 856 (4th Cir. 1995). The appellate court rejected the Tax Court's interpretation of the limitations period and held that a three-year "look-back" period applied. Because Lundy paid his 1987 taxes within three years prior to the date that the Commissioner mailed the notice of

deficiency, the court of appeals concluded that the Tax Court could order a refund and remanded the case to the Tax Court for that purpose.

On May 30, 1995, the Supreme Court granted the Commissioner's petition for a writ of certiorari to review the Fourth Circuit's decision. 115 S. Ct. 2244 (1995).

CASE ANALYSIS

This case concerns the limits on the Tax Court's jurisdiction to award refunds for federal income tax overpayments. The Supreme Court will interpret Sections 6511 and 6512 of the Internal Revenue Code (the "Code") to determine which "look-back" period applies when the IRS issues a statutory notice of deficiency more than two years after the return's due date and before the taxpayer files a return, and the taxpayer responds by contesting the deficiency notice in the Tax Court.

When the IRS mails a statutory notice of deficiency, a taxpayer who disagrees with the asserted deficiency can pay the tax and file a claim for refund. If the Commissioner denies the refund claim or does not act on the claim within six months, the taxpayer can sue the government in federal district court or the Court of Federal Claims.

But what course of action is available to a taxpayer who wants to contest a deficiency notice but cannot or does not want to pay the disputed tax first? The alternative is to proceed in the Tax Court. Within 90 days after the IRS mails a deficiency notice, a taxpayer can petition the Tax Court to review the asserted deficiency *without having to pay the tax*.

If the taxpayer files a timely petition in the Tax Court, Code Section 6512(b)(1) authorizes the Tax Court to review the notice of deficiency and also authorizes the Court to determine any overpayment that the taxpayer may have made for the same taxable year. 26 U.S.C. § 6512(b)(1) (1988). Under the circumstances in this case, however, Section 6512(b)(3)(B) limits any refund to the amount that Section 6511(b)(2) would allow "if on the date of the mailing of the notice of deficiency a claim had been filed (whether or not filed) stating the grounds upon which the Tax Court finds that there is an overpayment." 26 U.S.C. § 6512(b)(3)(B).

Section 6511(b)(2), which provides two "look-back" rules limiting refunds, in turn, directs attention to Section 6511(a). Under Section 6511(a), if the Code requires a taxpayer to file a return, the taxpayer must file a refund claim "within 3 years from the time the return was filed or 2 years from the time the tax was paid, whichever of such periods expires the later, or if no return was filed by the taxpayer, within 2 years from the time the tax was paid." 26 U.S.C. § 6511(a) (West Supp. 1995).

If the taxpayer filed a refund claim during the three-year period in Section 6511(a), the three-year "look-back" period of Section 6511(b)(2)(A) applies and the refund cannot exceed the tax paid within the three years immediately preceding the claim's filing. 26 U.S.C. § 6511(b)(2)(A) (West Supp. 1995). If the taxpayer did not file the claim within the three-year period in Section 6511(a), the two-year "look-back" period applies and the refund cannot exceed the tax paid during the two years before the claim's filing. 26 U.S.C. § 6511(b)(2)(B) (West Supp. 1995).



As noted above, the Code treats the taxes withheld from Lundy's wages during 1987 as paid on April 15, 1988. Lundy, therefore, paid his 1987 taxes more than two years before the Commissioner mailed the notice of deficiency on September 26, 1990, but less than three years before he filed his 1987 tax return on December 28, 1990. Consequently, this case centers on whether Subparagraph (A) or (B) of Section 6511(b)(2) applies. Lundy contends that Section 6511(b)(2)(A) controls; the Commissioner claims that Section 6511(b)(2)(B) governs. The Supreme Court will decide whether sending a deficiency notice to a non-filing taxpayer more than two years after a return's due date can preclude a taxpayer from obtaining a refund in the Tax Court.

The Commissioner argues that because Lundy had not filed any return for 1987 when the Service mailed the notice of deficiency, the two-year "look-back" rule in Section 6511(b)(2)(B) applies and precludes the Tax Court from granting Lundy a refund. In other words, the Commissioner contends that Section 6512(b)(3)(B) bars a taxpayer from obtaining a refund of an overpayment of income taxes in the Tax Court when the taxpayer's return is more than two years late and, in fact, is filed only after the Commissioner issues the notice of deficiency.

Under the Commissioner's interpretation, Section 6512(b)(3)(B) limits the amount of any refund that the Tax Court can order to the amount that the taxpayer could claim if the taxpayer had filed a claim for refund "on the date of the mailing of the notice of deficiency." The Commissioner, therefore, contends that the clause "if on the date of the mailing of the notice of deficiency a claim had been filed (whether or not

filed)" contained in Section 6512(b)(3)(B) assumes that the taxpayer filed a "deemed claim for refund" on the date the IRS mailed the notice of deficiency. But, because "on the date of the mailing of the notice of deficiency" Lundy had not filed a return, the Commissioner argues that Section 6511(b)(2)(B) limits Lundy's refund to the tax paid during the two-year period immediately preceding the refund claim. To the Commissioner, all of this means that no refund is due because the tax in dispute was deemed paid as of April 15, 1988, more than two years before the IRS mailed the deficiency notice on September 26, 1990.

In the Commissioner's view, the Fourth Circuit disregarded the plain language of the applicable Code provisions and reached a conclusion that conflicts with the Tax Court's consistent position and with prior decisions of the Second, Fourth, Sixth, Seventh, Ninth and Tenth Circuits. *Davison v. Commissioner*, 1993 U.S. App. LEXIS 31306 (2d Cir. 1993); *Anderson v. Commissioner*, 74 A.F.T.R.2d (RIA) 94-6222 (4th Cir. 1994); *Allen v. Commissioner*, 73 A.F.T.R.2d (RIA) 94-1765 (6th Cir. 1994); *Galuska v. Commissioner*, 5 F.3d 195 (7th Cir. 1993); *Rossmann v. Commissioner*, 75 A.F.T.R.2d (RIA) 95-809 (9th Cir. 1995), *petition for cert. filed*, No. 94-1747; *Richards v. Commissioner*, 37 F.3d 587 (10th Cir. 1994), *petition for cert. filed*, No. 94-1537.

The Commissioner also points out that in *Miller v. United States*, 38 F.3d 473 (9th Cir. 1994), the Ninth Circuit concluded that Section 6511 bars a taxpayer who fails to file a return for two years after the due date from claiming a refund in any forum, administrative or judicial.

In response, Lundy claims that the three-year "look-back" rule in Section 6511(b)(2)(A) applies because he filed his claim for refund within three years of filing his 1987 tax return, the time period that Section 6511(a) describes. Lundy, therefore, maintains that Section 6512(b)(3)(B) authorizes the Tax Court to order the Commissioner to refund his 1987 overpayment.

Lundy interprets the clause "whether or not filed" in Section 6512(b)(3)(B) as meaning "could have been filed." Under that construction, a taxpayer who could have filed a valid claim for refund on the date the IRS mailed a notice of deficiency can invoke the Tax Court's refund jurisdiction. In other words, Lundy argues that because the three-year period described in Section 6511(a) had not expired on the date the Service mailed the notice of deficiency, Section 6511(b)(2)(A) allows the refund of tax paid during the three-year period preceding his refund claim. Because he filed a refund claim on December 28, 1990, and because the Code treats the taxes withheld from his wages during 1987 as paid on April 15, 1988, Lundy contends that he is within the three-year "look-back" period and the Tax Court can order the Commissioner to refund his overpayment.

Lundy also maintains that conduct and statements of employees at all levels of the IRS, including Revenue Ruling 76-511, 1976-2 C.B. 428, contradict the Commissioner's argument that the plain language of Section 6512(b)(3)(B) requires the Supreme Court to reverse the Fourth Circuit's decision. Revenue Ruling 76-511 states that if a taxpayer files a return more than two but less than three years after its due date, the Service will allow the refund "since the overpayment

(Continued on Page 71)



would have been made within the 3-year period immediately preceding the filing of the claim." 1976-2 C.B. at 429. Lundy suggests that the Commissioner's statutory construction in this case sets a "trap for the unwary" — for taxpayers who have overpaid their taxes and unwittingly challenge a notice of deficiency in the Tax Court.

Finally, maintaining that the three-year "look-back" period applies to refund claims in federal district court and the Court of Federal Claims, Lundy argues that the Supreme Court should construe Sections 6511 and 6512 so that the same limitations period applies to refund claims in the Tax Court, in district court, and in the Court of Federal Claims.

SIGNIFICANCE

The IRS estimates that about 10 million people fail to file tax returns each year and that more than one-third of these non-filers actually overpaid their taxes. Even though a non-filer may have overpaid taxes, the absence of a return gets the Service's attention and often prompts the Service to seek additional tax. If the IRS issues a notice of deficiency, taxpayers generally prefer to challenge the asserted deficiency in the Tax Court because, as observed above, they do not have to pay the tax before appealing to that forum.

A Supreme Court decision in the Commissioner's favor would mean that if the IRS waits one day more than two years after a return's due date to send a deficiency notice to a

non-filing taxpayer, the IRS could preclude the taxpayer from obtaining a refund in the Tax Court. A decision in the Commissioner's favor also could cause the IRS to revise Revenue Ruling 76-511, an action that potentially could adversely affect taxpayers before the Service, the Tax Court, federal district court, or the Court of Federal Claims who seek refunds but who also filed tax returns between two and three years late.

ATTORNEYS OF THE PARTIES

For the Commissioner of Internal Revenue (Drew S. Days, III, Solicitor General; Department of Justice; (202) 514-2217).

For Robert F. Lundy (Lawrence J. Ross; (202) 223-5100).