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An Absolute Provision Is Not Always So Absolute, Revisited—*En Banc* Rehearing Brings Common Sense Back

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As previously discussed in The Journal,[1] it always seemed clear under the Code that the Service was required to issue a statutory notice of deficiency before making an assessment of income taxes.[2] The sanctity of this rule, however, was diminished in the Federal Circuit's holding in *Bush*, **105 AFTR 2d 2010-1687**, 599 F3d 1352 (CA-F.C., 2010) ("*Bush 1*"). There, the court held that, although the Service *should* have issued a statutory notice prior to assessing tax against the taxpayers, its failure to do so was simply a "harmless error" that did not entitle the taxpayers to a refund after they paid the erroneously assessed tax. The taxpayers quickly sought reconsideration of the case, and the Federal Circuit vacated the *Bush 1* decision and granted the taxpayers' request for a rehearing of the case *en banc*.[3]

The Federal Circuit, in its decision on rehearing in *Bush*, 108 AFTR 2d 2011-5941, 655 F3d 1323 (CA-F.C., 2011) ("*Bush 2*"), ultimately concluded, as it had in *Bush 1*, that the assessments were valid. The court in *Bush 2* adopted a new theory, however, rejecting the holding of the majority opinion in *Bush 1* and adopting the approach espoused by the concurring judge, to the effect that the assessment was permitted under an exception to the general rule that applies to "computational adjustments," following the resolution of a "partnership audit," so long as those adjustments do not "require partner level determinations."[4]

In the original Bush 1 decision, Judge Dyk wrote the majority opinion relying on harmless error, and Judge Prost wrote the concurrence, arguing that the assessment was solely a computational adjustment not requiring the issuance of a statutory notice. In the en banc proceeding, Judge Prost wrote the majority opinion explaining why the adjustment was solely computational, and Judge Dyk wrote the dissent.

PROCEDURAL BACKGROUND

Bush involved adjustments arising from two partnerships in which one of the taxpayers was a limited partner: Lone Wolf McQuade (LWM) and Cinema 84. In 1991, the Service mailed notices of final partnership administrative adjustment (FPAAs) for tax years 1983, 1984, 1985, and 1986 to the tax matters partner (TMP) of LWM, disallowing certain deductions reported on LWM's partnership returns for those years. The Service also issued FPAAs for Cinema 84's 1985-1989 tax years, disallowing certain deductions reported on the partnership returns for those years.

The respective TMPs of the two partnerships challenged the proposed adjustments by filing petitions in the Tax Court. While the partnership proceedings were still pending, the taxpayers entered into two separate Forms 906, "Closing Agreement on Final Determination Covering Specific Matters," with the Service on 8/7/99.

The closing agreements were intended to resolve both partnership-level issues and partner-level matters. Signing the closing agreements did not waive the taxpayers' rights under Section 6213(a) to receive a notice of deficiency prior to the assessment of additional tax computed in accordance with the closing agreements. The parties agreed that no adjustment was required for any of the items reported on the partnership returns. With regard to partner-level issues, the closing agreements determined the taxpayers' amounts at risk in the partnerships, and limited the deductions available at the partner level to those amounts at risk in the partnerships.

Specifically, the closing agreements provided that the amounts at risk would initially consist of $50,000 per partner (representing the original capital contribution), and would be adjusted upward if the partnership earned taxable income or the partners made additional cash contributions to the partnership. After signing the closing agreements, the taxpayers were dismissed by the Tax Court from the partnership proceedings.

In July 2000, the IRS issued "notices of adjustment" with respect to the taxpayers' returns for 1985, 1986, and 1987, and assessed deficiencies in tax based on the closing agreements' determination of the taxpayers' amounts at risk for those years. The Service did not issue any notices of deficiency prior to making the assessments. In August 2000, before the IRS initiated any collection proceedings on these assessments, the taxpayers paid the assessed tax in full.

During July 2002, the taxpayers filed refund claims with the Service, seeking a refund of the amounts paid during 2000. The IRS promptly denied the refund claims, and the taxpayers timely filed a refund suit in the Court of Federal Claims. As there were no material facts in dispute, both parties moved for summary judgment.

The taxpayers' motion was based on the argument that, because the Service had not issued notices of deficiency before making the post-settlement assessments, the assessments were unlawful, and the taxpayers were entitled to a refund of their payments of the assessed tax. [5] The government's cross-motion contended that the Service was not required to issue notices of deficiency because the assessments related solely to "computational adjustments" exempt from standard deficiency procedures.

The Court of Federal Claims granted summary judgment to the Service, the taxpayers appealed and, in *Bush 1*, the Federal Circuit affirmed the decision of the Court of Federal Claims, but on different grounds. The taxpayers then requested a rehearing before the Federal Circuit, which was heard *en banc.*

RELEVANT CODE PROVISIONS

The Service generally cannot assess and collect tax that it has determined is owed by a taxpayer without first issuing a deficiency notice to the taxpayer.[6] The taxpayer, after receiving a notice of deficiency, then has the option either to pay the tax (and ultimately to sue for a refund in either the Court of Federal Claims or a federal district court[7]) or to challenge the Service's deficiency determination, prior to paying the tax, by filing a petition in the Tax Court. A Tax Court filing stays assessment and collection activities until the Tax Court proceedings are completed.[8]

When a dispute arises regarding items shown on a partnership return, however, the rules regarding the requirement of the issuance of a notice of deficiency are modified. Generally, after the partnership audit, the Service mails an FPAA to the TMP and to each partner of the partnership for which the IRS has notice of name and address, setting forth the proposed adjustments.[9]

The partners may then file a petition for a readjustment of the partnership items in the Tax Court, the appropriate district court, or the Court of Federal Claims.[10] Each partner can either participate in the partnership proceeding or, as the taxpayers in this case did, settle on his own with the Service.[11] Until resolution of the proceeding as to a partner (or the partners' failure to file a petition for readjustment in the Tax Court), assessment and collection activities are prohibited.[12]

When issues are resolved with any partner by settlement, no notice of deficiency is required if the IRS is simply assessing against the partner an amount attributable to a "computational adjustment" that does *not* require a "partner-level determination."[13] A "computational adjustment" is a change in the tax liability of a partner which properly reflects the treatment of the settled partnership items,[14] and a "partnership item" is any item on a partnership return whose treatment is better handled at the partnership level than at the partner level.[15]

A "partner-level affected item" is an "affected item" that requires partner-level determinations, and an "affected item" is defined as "any item to the extent that such item is affected by a partnership item."[16]

QUESTIONS FOR THE FEDERAL CIRCUIT

In light of these statutory provisions, one would have expected the Federal Circuit to focus on whether the taxpayer's tax deficiency arose from (1) a computational adjustment, and if so, (2) whether it was attributable to an affected item that (3) required a partner-level determination. Indeed, in *Bush 1* the Federal Circuit held that the deficiency was not attributable to a computational adjustment, and thus that the Service should have issued a notice of deficiency. Notwithstanding that conclusion, however, the court held that failure to issue a notice of deficiency was "harmless error" and held the assessments against the taxpayers to be valid.

In connection with the *en banc* rehearing, the Federal Circuit requested additional briefings from the parties addressing four issues:

(1) Under **Section 6213**, were taxpayers in this case entitled to a preassessment deficiency notice? Were the assessments the results of a "computational

adjustment" under **Section 6230** as that term is defined in **Section 6231(a)(6)**?

(2) If the IRS were required to issue a deficiency notice, does **Section 6213** require that a refund be made to the taxpayers for amounts not collected "by levy or through a proceeding in court"?

(3) Are taxpayers entitled to a refund under any other section of the Code? For example, what effect, if any, does an assessment without notice under **Section 6213** have on stopping the running of the statute of limitations?

(4) Does the harmless error statute, 28 U.S.C. section 2111, apply to the government's failure to issue a deficiency notice under **Section 6213** ? If so, should it apply to the taxpayers in this case?

THE MAJORITY

The taxpayers argued that the Service's assessment against them could not be viewed as a "computational adjustment" because the IRS did not change any aspect of its treatment of a partnership item, and a computational adjustment is by definition a change in the tax liability of a partner that reflects the treatment of a partnership item. The closing agreement expressly stated that "[n]o adjustment to the partnership items shall be made...."

The Service, however, noted that the definition of "computational adjustment" does not require a "change" to a partnership item, but merely refers to the *treatment* of such item. Therefore, the IRS argued, any determination of partnership items in a TEFRA proceeding, including making no adjustment to the partnership items as they were reported, constituted "treatment" of the partnership items.

The majority used this opportunity to expand on its lengthy grammatical argument in the earlier concurrence in *Bush 1.* The Federal Circuit noted that the word "change" in the statute modifies "the tax liability of a partner," while the word "treatment" modifies the phrase "of a partnership item." Thus, it is the partner's tax liability that must change, not necessarily the treatment of any partnership item. As the Federal Circuit noted, "had Congress intended to limit 'computational adjustments' to tax liability changes arising from *changes* in treatment of a partnership item, it could have used the word 'change' or 'change in treatment' rather than the word 'treatment' alone." (Emphasis in original.)

The Federal Circuit relied on the reasoning in *Olson,* **83 AFTR 2d 99-759**, 172 F3d 1311 (CA-F.C., 1999), to support its conclusion. *Olson* held that assessments are characterized as "computational adjustments" when they require "no individualized factual determination" as to the correctness of the original partnership items or "any other factual matter such as the state of mind of the taxpayer upon filing." Under the *Olson* rationale, the Bushes' post-settlement adjustment was "computational" because, after the closing agreement was signed, there was nothing left to do but perform a calculation to determine the correct tax liability.

The Federal Circuit noted that had the TEFRA proceeding been completed and the Service prevailed, the claimed losses would have been disallowed and the IRS would have undisputedly assessed the taxes via a computational adjustment. Instead, the taxpayers here chose to settle and agreed to formulas to recalculate their at-risk amount, which thus affected the amount of loss they could claim on their personal returns. By choosing to settle rather than participate in the Tax Court proceeding, the Federal Circuit said, taxpayers should not be allowed to alter the character of the adjustment as a computational adjustment.

Thus, the Federal Circuit held that the assessments were computational adjustments. Nevertheless, notices of deficiency still would be required for any deficiencies arising from computational adjustments if the Federal Circuit found that they were attributable to affected items which required partner-level determinations.[17]

As previously explained, an "affected item" is "any item to the extent such item is affected by a partnership item."[18] It thus includes two parts, a nonpartnership component that is affected by the partnership component. The Federal Circuit agreed with the analysis of the Court of Federal Claims that the at-risk amount may be an affected item with both a partnership component and a nonpartnership component. Despite the fact that it might be an affected item, the Federal Circuit found that no partner-level determinations were required.

The Court of Federal Claims had noted that "a settlement is usually applied to a partner by means of a computational adjustment and not under the ordinary deficiency and refund procedures."[19] In the closing agreement, the taxpayers agreed that the at-risk amount would be "their capital contribution to the partnership," and then agreed that the capital contribution was $50,000 per partner. The remaining paragraphs in the closing agreement defined the ways in which this at-risk amount might change (i.e., if the taxpayers made additional cash contributions to the capital of the partnership).

Simply because these at-risk amounts might be specific to the individual partner did not mean that they were partner-level determinations. As in *Olson,* all that remained after the settlement was to apply the stipulated computations in the closing agreement to the values from the taxpayers' returns and assess the tax. There was no need to collect any additional information from the taxpayers or make any factual determinations.

The Federal Circuit thus affirmed the judgment of the Court of Federal Claims. The changes in tax liability that arose from the closing agreements were computational adjustments but, to the extent that the at-risk amounts were affected items, they did not require any partner-level factual determinations. Therefore, the court held that the Service was correct to directly assess these taxes without first issuing a notice of deficiency and no refunds should be granted.[20]

THE DISSENT

Circuit Judge Dyk wrote the dissent in this case. As noted above, he had previously written the majority opinion in *Bush 1.* Judge Dyk based his dissent on the fact that the closing agreement specifically said: "No adjustment to the partnership items shall be made ... for purposes of this settlement." Thus, he concluded, the change in liability of the taxpayers could not result from the

treatment of a partnership item but must instead result from a change in the treatment of an individual partner-level item (i.e., the agreement to cap the at-risk amount of the individual partners).

Because no partnership item was involved, Judge Dyk argued that there could be no computational adjustment. To emphasize his point, he noted that the closing agreement adjusted the at-risk amount after stating that no adjustments were being made to any partnership items, and thus this was evidence that the IRS clearly did not view the at-risk amount as a partnership item.

Having concluded that a "computational adjustment" was not involved, the dissenting opinion did not need to address the additional questions of whether an "affected item" was involved that required a partner-level determination.

Rather than rely on the theory in *Bush 1* of harmless error to allow the assessment to be valid regardless of the Service's failure to issue a statutory notice, the dissent focused on a new theory that had been raised in briefs filed during the *en banc* rehearing. This was the issue of whether the taxpayers were even entitled to a refund because the Code provides only for an automatic refund in circumstances where the tax is collected during a period in which collection by levy or through court proceedings is prohibited.[21]

The Bushes voluntarily paid the assessments before the IRS ever initiated any collection proceedings. The taxpayers did not argue that they paid amounts that otherwise would not be owing if the limitations period had not yet expired at the time payment was made. Under *Lewis v. Reynolds*, **10 AFTR 773**, 284 US 281, 76 L Ed 293, 1932-1 CB 130 (1932), if the statute of limitations had not yet expired, the Service's failure to issue the required statutory notice before assessing or collecting the tax does not require the issuance of a refund. Other circuits also have held that the timely payment of taxes properly due is not an overpayment for which a refund could be claimed.[22] As it was not clear from the facts before the Federal Circuit if the statute of limitations had run before the payment was made (in which event a refund would be due), the dissent would have remanded this case to the Court of Federal Claims to address this issue.

THE SHADOW OF THE HARMLESS ERROR

By holding the ways that they did, neither the majority nor the dissent in *Bush 2* was forced to address the harmless error theory that had been so heavily relied on in *Bush 1*. Both parties had requested that the court withdraw that portion of its opinion.

The taxpayers argued that the court was limiting taxpayer due process protections by creating judicial, common-law exceptions to the statutory requirement of issuing a deficiency notice.[23]

The government argued that there was no due process violation as the parties were not denied access to meaningful judicial review but agreed that the harmless error standard was not applicable in tax cases. An assessment made without the prior issuance of a notice of deficiency or an applicable statutory exception would be forever void and illegal and no harmless error theory could overcome this.[24]

The government in *Bush 2* was willing to go so far as to concede the case rather than have the harmless error theory apply. The government concluded its brief by stating that the assessments were computational adjustments that did not require the issuance of deficiency notices, but if the court should find that the Service should have issued deficiency notices, then agreed that the assessments would have been invalid.[25]

As the majority concluded that the assessments were indeed solely computational adjustments, the harmless error theory was removed from the tax landscape.

CONCLUSION

The tide turned sometime between *Bush 1* and *Bush 2*. Whether it was the parties' briefs, the amicus curiae briefs, or the numerous articles written on *Bush 1*, the majority and concurrence of *Bush 1* switched places to become the dissent and the majority in *Bush 2*. Even the dissent, however, gave up on its earlier unsustainable harmless error approach and relied on a new theory to possibly deny the refund request. The switch allowed the *en banc* court to provide a well-reasoned decision that taxpayers can rely on for guidance in the future.

Unfortunately, this is an area that is still in need of legislative or regulatory guidance. On 12/27/11, the Tax Court held in *Thompson*, **137 TC No 17** (2011), that computing a tax deficiency that arose from adjustments finalized in the partnership-level proceeding did not require partner-level determinations and thus no notice of deficiency was required. There were, however, two different dissenting opinions, and one judge who concurred with the majority in result only. As one of the dissenting judges concluded, "The silt we stir today will cloud the cases we plunge into tomorrow."

1 See Brody, "The Requirement for a Deficiency Notice—When an Absolute Provision Is Not Always Absolute," 113 JTAX 68 (August 2010).

2 See generally Section 6213(a) .

3 Bush, 106 AFTR 2d 2010-6909, 400 Fed Appx 556 (CA-F.C., 2010).

4 See Sections 6230(a)(1) and (a)(2)(A)(i). In addition, a taxpayer may waive the right to a notice of deficiency and voluntarily permit an assessment in the absence of a notice; see Section 6213(d) . The IRS did not assert in this case that it had obtained a waiver.

5 Bush, 100 AFTR 2d 2007-5655, 78 Fed Cl 76 (Fed. Cl. Ct., 2007).

6 Section 6213(a).

7 28 U.S.C. section 1346(a)(1).

8 Section 6213(a).

9 See Sections 6223(a) and (d)(2).

10 Sections 6226(a)(1) through (3). The Code contains elaborate rules to determine which proceeding goes forward if petitions are filed by partners in more than one court.

11 See Section 6224(c)

12 Section 6225(a).

13 Section 6230(a)(1). Assessments similarly can be made at the conclusion of any Tax Court proceeding, or shortly after the issuance of an FPAA if a Tax Court proceeding is not commenced.

14 Section 6231(a)(6).

15 Section 6231(a)(3).

[16] Section 6231(a)(5).

[17] Section 6230(a)(2)(A)(i).

[18] Section 6231(a)(5).

[19] Quoting Bob Hamric Chevrolet, Inc., 73 AFTR 2d 94-1905, 849 F Supp 500 (DC Tex., 1994).

[20] Because the court concluded that the assessments in this case amounted to computational adjustments and no deficiency notices were necessary, the three remaining questions briefed by the parties were not addressed in the majority's opinion.

[21] Section 6213(a).

[22] See, e.g., Williams-Russell & Johnson, Inc., 93 AFTR 2d 2004-2543, 371 F3d 1350 (CA-11, 2004).

[23] Appellants' opening Brief *En Banc*, pages 40-41.

[24] *En Banc* Brief for the Appellee, page 68.

[25] *Id.*, page 75. The case then would have had to be remanded as only payments that the taxpayers had made after the expiration of the statute of limitations would be refunded.