Tax Controversy Corner

The Variance Doctrine: An Important Variable to Consider When Drafting Refund Claims

*By Megan L. Brackney**

If you are preparing, or advising on, the filing of amended returns or other claims for refund, one of the most important things to consider is the variance doctrine, and how it could impact your client's ability to bring a refund action in court if the IRS denies the claim.

Federal district courts and the Court of Claims have jurisdiction over refund actions, where the plaintiff (i) timely filed an administrative claim with the IRS that satisfies the requirements set forth in Reg. §301.6402-2[1]; (ii) paid the required amount of the assessment; and (iii) filed the complaint within two years of the notice of disallowance of the refund claim.[2] Compliance with these requirements is a prerequisite to subject matter jurisdiction.[3]

This column focuses on the requirements of Code Sec. 7422(a) and Reg. §301.6402-2, which establish what is known as the "variance doctrine."

The General Variance Rule

Reg. §301.6402-2(b)(1) states:

> The claim must set forth in detail each ground upon which a credit or refund is claimed and facts sufficient to apprise the Commissioner of the exact basis thereof. … A claim which does not comply with this paragraph will not be considered for any purpose as a claim for refund or credit.

Courts have interpreted Reg. §301.6402-2(b)(1) as barring a taxpayer from presenting claims in a tax refund suit that "substantially vary" from the legal theories and factual bases set forth in the tax refund claim presented to the IRS.[4] Accordingly, a taxpayer is barred from raising in a refund suit a claim for recovery which it did not include in its claim for a refund.[5] The corollary of the variance rule is that both the factual and legal bases for a tax refund claim must be specifically stated.[6]

The reasons for the variance rule include that it (i) gives the IRS notice as to the nature of the claim and the specific facts upon which it is predicated and prevents surprise; (ii) gives the IRS an opportunity to correct errors; and (iii) limits subsequent litigation to those grounds that the IRS had an opportunity to consider and is willing to defend.[7] The Supreme Court also has described the variance doctrine as protecting the IRS from "dilatory, careless and wasteful fiscal administration by barring incomplete or confusing claims."[8]

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Exceptions to the Variance Rule

There are a few limited exceptions to the variance rule, including when the government raises new defenses or counterclaims, the government waives the right to object, and the general claims doctrine. Each of these exceptions is discussed below.

First, the taxpayer will not be barred from responding with new facts or legal theories when the government raises new defenses or counterclaims for the first time in litigation.[9] In this sense, "the Government cannot use the variance doctrine to straightjacket the taxpayer when the Government unexpectedly changes its litigation strategy."[10]

As can be seen from the above discussion, failure to comply with the variance rule may result in the loss of opportunity for judicial review of the IRS's actions. Understanding the variance doctrine is the first step to avoiding dismissal.

This exception was addressed in *El Paso CGP Co.*[11] In that case, El Paso and the IRS had entered into a settlement agreement that disallowed various tax credits but permitted El Paso to replace those disallowed credits with other credits that had been carried forward to later tax years.[12] This caused El Paso to have overpaid for some years, and it thus filed a refund suit in federal district court to preserve its rights.[13] Later, El Paso and the IRS reached a tentative agreement on the amounts that each party was due, or owed, for each year, after the tax credits were rearranged.[14] After finalizing the closing agreement, the IRS set off some of El Paso's refunds to satisfy its deficiencies, and El Paso filed an informal refund claim asserting that the IRS had not properly assessed the deficiencies before the statute of limitations expired and failed to follow the mitigation rules. The IRS denied this informal claim, and El Paso filed a refund suit in federal district court based on the original refund claim.[15]

In the district court, the government successfully argued that the court did not have jurisdiction over El Paso's refund claim because El Paso's arguments regarding the IRS's setoff were not contained in the original refund claim.[16] The Fifth Circuit reversed. The Court explained that "[a]lthough the variance doctrine has been expressed in uncompromising terms, courts have not always been so dogmatic in applying it. Sensibly, courts have explicitly carved out an exception in cases where the Government's unilateral action itself creates the substantial variance."[17] The Fifth Circuit recognized an exception to the variance doctrine when the new claim arises from the IRS's conduct after the refund suit was filed. The court explained that the IRS allegedly violated certain procedures in offsetting El Paso's refund after El Paso had filed suit, and as that was the only variance in El Paso's claim, it would not apply the variance rule.[18]

In *Cencast Serv., L.P.*,[19] the taxpayer argued that it should be allowed to raise a new claim in litigation as a defense to the government's setoff claim. The term "setoff" in this context referred to the government's claim that a taxpayer's recovery should be reduced based on other amounts owed to the government for the same tax year.[20] "Implicit" in the setoff procedure "is the subsequent right of the taxpayer to raise a setoff to defendant's newly raised setoff, *i.e.*, a counter-setoff."[21] The *Cencast* court found that the government's counterclaim did not raise new issues because it was based on the same theory that the IRS had asserted throughout the administrative process and refused to consider the taxpayer's counter-setoff arguments.[22]

As can be seen from the *El Paso* and *Cencast* decisions, the exception for new arguments is very narrow and will apply only when the government's setoff claim or other counterclaim does, in fact, raise an entirely new issue.

The next exception is when the government waives the right to object to a variance between the grounds in the refund claim and those raised in litigation. A claim may be considered timely if the taxpayer files a timely formal claim and fails to include the specific claim for relief, but the IRS considers that specific claim within the limitations period.[23] As explained by one court, the central purpose of the waiver doctrine is "to prevent IRS agents from lulling taxpayers into missing the [limitations] deadline … "[24]

The waiver exception only applies if the IRS considers the specific claim during the administrative proceeding.[25] Similar to the rationale behind the general claim exception discussed below, the waiver exception is concerned with notice to the IRS. The IRS has notice of a claim when it examines a particular claim, even though the taxpayer did not specifically set it out in the refund request.[26] Courts will find that the IRS has waived the variance rule, however, only where there is "convincing evidence that the IRS examined the merits of a particular claim and took action upon it."[27] The taxpayer has to show more than that the IRS was aware of an issue but that it investigated the underlying facts. The court will not find a waiver "where the evidence of such focus and intent" is "absent or inconclusive."[28]

In describing the parameters of the waiver exception, the Supreme Court explained:

> Since, however, the tight net which the Treasury Regulations fashion is for the protection of the revenue, courts should not unduly help disobedient refund claimants to slip through it. The showing should be unmistakable that the Commissioner [of the IRS] has in fact been fit to dispense with his formal requirements and to examine the merits of the claim. It is not enough that in some roundabout way the facts supporting the claim may have reached him.[29]

In *Angelus Milling*, the plaintiffs argued that there was a waiver because the IRS had requested to examine the books and records of the corporation. The Supreme Court found that this evidence did not provide a clear indication that the IRS reviewed the documents for the purpose of considering the taxpayer's particular claim.[30] Similarly, in *Friedmann*, the plaintiffs claimed that the IRS waived the substantial variance between the refund claim and the complaint because the IRS had access to all of the plaintiffs' books and records during discovery. The court, however, found that this was not enough because it did not establish "unmistakable" evidence that the IRS had investigated the plaintiffs' specific claims.[31]

The next exception, known as the "general claim doctrine," is not so much an exception to the variance doctrine, but a method that aids taxpayers in mitigating the harshness of the variance rule. The general claim doctrine applies where (i) the taxpayer has filed a formal general claim within the limitations period; and (ii) an amendment is filed outside the limitations period that makes the general claim more specific.[32] The Supreme Court recognized this doctrine in *Andrews*:

> Where a claim which the Commissioner could have rejected as too general, and as omitting to specify the matters needing investigation, has not misled him but has been the basis of an investigation which disclosed facts necessary to his action in making a refund, an amendment which merely makes more definite the matters already within his knowledge, or which, in the course of his investigation, he would naturally have ascertained, is permissible.[33]

Under this doctrine, an amendment filed outside the limitations period is considered timely where the original claim merely stated the amount of the tax paid, the correct tax, and the amount of overpayment.[34] The general claim doctrine only applies when the original claim is general rather than specific. Accordingly, when the original timely return includes a specific ground, it cannot be amended outside of the statute of limitations to include additional bases for relief.[35]

Practitioner Tips for Avoiding Variance Problems

As can be seen from the above discussion, failure to comply with the variance rule may result in the loss of opportunity for judicial review of the IRS's actions. Understanding the variance doctrine is the first step to avoiding dismissal. Below are some additional tips for complying with the variance rule:

1. Take the time to fully research the facts and legal arguments on which the refund claim is based, and make sure to state them all. So long as the potential grounds for relief meet the standards for return positions stated in Code Sec. 6694 and Circular 230 §10.34, *i.e.*, they are not unreasonable, all grounds should be included so that you are able to present them in court later if the claim is denied.
2. If the client comes to you at the last minute, you may not have time to thoroughly research the claim and present all possible arguments to the IRS before the statute of limitations for the refund claim expires. In this situation, consider filing a general claim for refund, and then, pursuant to the general claim doctrine, later amend the refund claim to include the specific factual and legal claims.
3. If you uncover a new theory in support of the refund claim, and the statute of limitations has not yet run, submit a new or amended claim for refund rather than risk dismissal on the grounds of variance in district court of the Court of Claims.
4. If the original claim was specific, and you discover a new basis for relief, attempt to raise the new issue during the administrative proceedings. If the IRS considers the position, and later rejects it, you may have an argument that the government has waived the application of the variance rule.

ENDNOTES

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1 Code Sec. 7422(a) requires that tax refund claims comply with "the regulations of the Secretary established in pursuance thereof."

2 28 USC §1346(a)(1); Code Sec. 7422(a); Reg. §6532(a)(1); *W.W. Flora*, SCt, 60-1 USTC ¶9347, 362 US 145, 177, 80 SCt 630.

3 *J.M. Quarty*, CA-9, 99-1 USTC ¶60,338, 170 F3d 961, 972.

4 *R.H. Cook*, CtCls, 79-1 USTC ¶9335, 599 F2d 400, 220 CtCls 76, 87.

5 *Mallette Bros. Const. Co.*, CA-5, 695 F2d 145, 155 (citations omitted); *see also Friedmann*, DC-NJ, 107 FSupp2d 502, 506 (2000) (dismissing cause of action

because it was not only "arguably inconsistent from the Plaintiffs' original refund claim, but the record shows that the Plaintiffs waited to provide the IRS with adequate documentation for both theories of recovery until the start of discovery in this litigation").

[6] *Lockheed Martin Corp.*, DC-FC, 210 F3d 1366, 1371 (citing *Burlington N. Inc.*, CtCls, 231 CtCls 222, 225 (1982)); *see also Levitsky*, FedCl, 27 FedCl 235, 241 (1992) ("[i]t is not enough that in some roundabout way the facts supporting the claim may have reached" the attention of the IRS).

[7] *Lockheed Martin Corp.*, 210 F3d 1371; *Forward Communications Corp.*, CtCls, 221 CtCls 582, 623 (1979).

[8] *Angelus Milling Co.*, SCt, 45-1 USTC ¶9310, 325 US 293, 297, 65 SCt 1162.

[9] *El Paso CGP Co.*, CA-5, 748 F3d 225 (citing *Shore*, 26 ClCt 826, 828–829 (1992) (rejecting variance doctrine argument where the government created the substantial variance from the original claim)); *Brown*, CA-9, 427 F2d 57, 62 (taxpayers "cannot be foreclosed from responding" to new issues created by the government after initial refund claim filed).

[10] *El Paso*, 748 F3d 229.

[11] *Id.*, at 225.

[12] *Id.*, at 226.

[13] *Id.*, at 226–227.

[14] *Id.*, at 227.

[15] *Id.*

[16] *Id.*, at 228–229.

[17] *Id.*, at 229.

[18] *Id.*

[19] *Cencast Serv., L.P.*, FedCl, 94 FedCl 425 (2010).

[20] *Id.*, at 441.

[21] *Id.*

[22] *Id.*, at 422.

[23] *Computervision Corp.*, DC-FC, 445 F3d 1355, 1365. The limitations period for refund claims is the later of three years after the return was filed or two years after the tax was paid. Code Sec. 6511(a).

[24] *BCS Financial Corp.*, CA-7, 118 F3d 522, 526.

[25] *Computervision*, 445 F3d 1365.

[26] *See id.*, at 1366.

[27] *Friedmann*, 107 FSupp2d 506.

[28] *Id.*, at 507.

[29] *Angelus Milling*, 325 US 297.

[30] *Id.*, at 298.

[31] *Friedmann*, 107 FSupp2d 507; *see also Cencast*, 94 FedCl 445 ("five scattered references" insufficient to prove "unmistakable" evidence that the plaintiffs had notified the IRS about the grounds for their refund claim).

[32] *Andrews*, SCt, 302 US 517, 524 (1938).

[33] *Id.*

[34] *Memphis Cotton Oil*, SCt, 288 US 62, 64–65 (1933).

[35] *Henry Prentiss & Co.*, SCt, 3 USTC ¶1027, 288 US 73, 83, 53 SCt 283; *see also Computervision*, 445 F3d 1368–1369 (rejecting application of general claim doctrine when original refund included a specific request for relief).