DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

CC:EL:GL:Br2:ICPlucinski
GL-106015-00

March 29, 2000

MEMORANDUM FOR JACK HOLSTEIN
DIRECTOR, INNOCENT SPOUSE PROGRAM

FROM: Eliot D. Fielding
Associate Chief Counsel (Enforcement Litigation)

SUBJECT: Reversal of Offset in Innocent Spouse Cases

In a memorandum dated December 28, 1999 (attached), we provided your office with guidance regarding whether and how the Service can correct an offset of a taxpayer's current year overpayment to a tax liability with respect to which an innocent spouse claim was filed. This memorandum supplements the December 28, 1999, advice on this issue.

BACKGROUND

Despite a taxpayer's election to seek relief under I.R.C. § 6015, an overpayment of tax arising under section 6401 may legally be applied to a liability with respect to which relief was requested (hereinafter "election year liability"). I.R.C. § 6402(a). The Internal Revenue Service ("Service"), however, has made an administrative policy decision to exercise its discretion under I.R.C. § 6402(a) not to offset a requesting spouse's overpayments generated after an innocent spouse claim has been filed and while the claim is under consideration. Thus, if the requesting spouse has no other outstanding tax liabilities, an overpayment generated after a claim under section 6015 has been filed is refunded to the requesting spouse.[1]

[1] The nonrequesting spouse's refunds are generally frozen pending the innocent spouse determination. Once the innocent spouse issue is determined, the refund is generally applied against the election year liability.

The administrative policy decision regarding offsets of overpayments to the election year liability was first communicated to all innocent spouse program coordinators via email on May 5, 1999. The policy was subsequently embodied in a memorandum from the Chief Operations Officer, dated January 12, 2000.[2] To effectuate this policy, the affected personnel were instructed to input a transaction code (TC) 470, closing code 90 (except for cases in status 26). The code generates a "W-" freeze (innocent spouse claim pending), which is designed to prevent delinquency notices from generating and overpayments from posting to the election year liability. Moreover, if the requesting spouse owes no other tax liabilities, the TC 470 allows a refund to be generated to the requesting spouse.[3]

The TC 470 and TC 130 codes are placed on the affected accounts at the time the requesting spouse's claim for relief is received by the Service. Unfortunately, the TC 470 has numerous systemic limitations that lead to the automatic release of the "W-" freeze and may result in an offset of a refund against the election year liability. First, the TC 470 has a maximum life of 26 cycles (26 weeks). This means that at the end of the 26 weeks the code automatically releases, leaving the account vulnerable to offsets. Second, the code is also designed to self-release for other reasons, such as a change in the account's status. Finally, there are limitations on when the Service can post the TC 470 to the taxpayer's account.

Currently, the Service has over 51,000 pending innocent spouse cases. In approximately 3,000 of these cases, the systemic release of the "W-" freeze has resulted in an application of the requesting spouse's current year (1999) overpayment to the election year liability. In addition, in some of these cases, the offset resulted in a hardship to the requesting spouse. You would like to know whether the Service can reverse the application of these offsets in order to generate refunds to the affected taxpayers. You further seek our advice regarding whether, if the Service subsequently

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[2] The policy is intended to benefit taxpayers whose application for relief is granted. The bulk of innocent spouse relief is granted on the basis of qualification under section 6015(c). No refunds are allowed under section 6015(c). In addition, where relief is granted under section 6015(f), refunds are limited to payments made pursuant to an installment agreement that has not been defaulted, and those made between July 22, 1998, and April 15, 1999. See I.R.C. § 6015(e)(3)(A) and Rev. Proc. 2000-15, 2000-5 IRB 447 (Jan. 31, 2000).

[3] Unlike the TC 470, the TC 130, which is input to the nonrequesting spouse's account, prevents overpayments from refunding. The TC 130 generates a report prompting the Service to review the nonrequesting spouse's account. A refund can be issued to the nonrequesting spouse only if generated manually.

determines that the requesting spouse is not entitled to relief under section 6015, the Service can collect the election year liability administratively or whether it must initiate an erroneous refund suit against the requesting spouse.

LAW & ANALYSIS

Regardless of other limitations that may exist on the Service's ability to undo an offset made in accordance with I.R.C. § 6402(a), the Service may generally correct any action that resulted from a clerical or bookkeeping error so long as the correction does not prejudice the taxpayer. Matter of Bugge, 99 F.3d 740 (5th Cir. 1996); Crompton-Richmond Co. v. United States, 311 F. Supp. 1184 (S.D.N.Y. 1970); Kroyer v. United States, 73 Ct. Cl. 591, 55 F.2d 495 (1932).

In the paramount case in this area, Crompton-Richmond, the Service timely assessed a section 6672 trust fund recovery penalty (TFRP) against the corporate taxpayer. The corporate taxpayer paid the penalty and sued the Service for a refund. During the suit, the Service filed various third-party responsible persons claims, including one against Vincent De Sousa. While the lawsuit was still pending, the district director requested abatement of the TFRP assessment against De Sousa. According to the court, this request was based on the Service's longstanding policy and practice of collecting the TFRP only once. Crompton-Richmond, 311 F. Supp. at 1185. The regional service center correctly rejected the district director's request due to the pending lawsuit. Before the district director was notified of the rejection of his request, he filed a second request to abate De Sousa's penalty. This second request was mistakenly granted. When the Service discovered its error, it immediately reversed the abatement and reinstated the assessment. The reversal, however, occurred after the statute of limitations on assessment had expired.

The court found that the abatement of De Sousa's liability was not made after a reconsideration of De Sousa's liability but rather represented "plain ordinary clerical or bookkeeping errors arising out of the failure of some IRS office personnel to appreciate that there was a pending refund suit." Id. at 1185-86. The court held that "[w]henever an abatement is issued because of a mistake of fact or bookkeeping error, the assessment can be reinstated, at least so long as this does not prejudice the taxpayer." Id. at 1187. The court, thus, allowed the Service to reinstate the assessment against De Sousa.

While the holding in Crompton-Richmond may be limited to its facts, we believe that the doctrine of "clerical error" is equally applicable to the case at hand. In this situation, the Commissioner has implemented a policy not to offset a requesting spouse's overpayments of tax generated after a section 6015 claim has been filed and while the claim is pending with the Service. Nevertheless, due to limitations of the Service's

computer system, the limited staffing, and the unexpectedly large volume of innocent spouse claims filed since the effective date of section 6015, a significant number of taxpayers requesting innocent spouse relief had their overpayments for the 1999 tax year applied to the election year liability. As such, the Service's failure or inability to adequately monitor and timely update the affected accounts in order to prevent offsets to the election year liabilities was inadvertent and unintended, i.e., clerical in nature. Accordingly, the Service may reverse and correct the offset as a "clerical error" in accordance with Crompton-Richmond and its progeny.[4]

The more important question in this case, however, is whether the erroneous (and temporary) application of the overpayment to the election year liability prevents the Service from administratively collecting the tax from the liable spouse or spouses after the requesting spouse's claim for relief is decided.[5] As you know, there is a line of cases which hold that when a taxpayer tenders a payment on a tax assessment, the assessment is extinguished to the extent of the payment, and the issuance of an erroneous refund does not revive the previously paid assessment.[6] See Bilzerian v. United States, 86 F.3d 1067 (11th Cir. 1996); Clark v. United States, 63 F.3d 83 (1st Cir. 1995); O'Bryant v. United States, 49 F.3d 340 (7th Cir. 1995); United States v. Wilkes, 946 F.2d 1143 (5th Cir. 1991). It is our position, however, that not every credit to a taxpayer's account constitutes a payment in satisfaction of an assessment. This position is contained in an Action on Decision we issued in response to the Eleventh Circuit's opinion in Bilzerian v. United States, 86 F.3d 1067 (11th Cir. 1996). See Bilzerian, supra, Action on Decision 1998-002 (September 2, 1998). Thus, when the Service inadvertently misapplies a taxpayer's payment that the taxpayer designated to another tax year, the assessment to which the payment was mistakenly applied is

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[4] Since the reversal of the offset is likely to benefit the electing spouse, there is no "prejudice to the taxpayer." See Matter of Bugge, 99 F.3d 740 (5th Cir. 1996); Crompton-Richmond Co. v. United States, 311 F. Supp. 1184 (S.D.N.Y. 1970).

[5] If the Service determines that the requesting spouse is not entitled to relief under section 6015, both spouses continue to be liable for the election year liability. If the Service grants relief to the requesting spouse, only the nonrequesting spouse will remain liable for the tax with respect to which election was requested.

[6] Please note that in all of these cases, the Service's mistake in crediting the taxpayer's account resulted in an unsolicited erroneous refund to the taxpayer. In the instant situation, the reversal of the offset and the subsequent refund to the requesting spouse is neither unintended, unsolicited, nor erroneous in nature.

not extinguished, and the Service can continue to collect that assessment after the correction of the misapplication. Likewise, when the Service returns funds collected as a result of a levy to a taxpayer pursuant to I.R.C. § 6343(d), the liability to which the funds were applied is not extinguished and the Service need not resort to the erroneous refund procedures to recover the funds refunded to the taxpayer. The case at hand is analogous to the above-described situations.

The case law recognizes that a tax is generally not satisfied by the Service's error in application of the taxpayer's payment. Clark v. United States, 63 F.3d 83 (1st Cir. 1995); United States v. Wilkes, 946 F.2d 1143 (5th Cir. 1991). In Clark, for example, the Service applied a taxpayer's payment that was designated to the 1986 taxes to the 1985 tax year, yielding a refund to the taxpayer. When the Service discovered its mistake, the credit was moved to the 1986 year, resulting in a balance due for 1985. Instead of filing an erroneous refund suit under I.R.C. § 7405, the Service levied on the taxpayer's bank account to collect the balance due with respect to the 1985 year.

In determining whether the Service was entitled to collect the allegedly unpaid 1985 tax liability, the First Circuit first examined the issue of whether a tax assessment can be "extinguished" by a taxpayer's payment. While the court generally accepted the Government's distinction between a rebate and nonrebate refund, it found the Government's argument that an assessment is merely a bookkeeping device that cannot be extinguished unpersuasive. Clark, 63 F.3d at 87-88. The court subsequently looked at which of the two tax assessments was "extinguished" by the taxpayer's payment. Finding that "assessments may only be extinguished by payment tendered by the taxpayer, and not by an IRS error," the court held that the misapplication of the 1986 payment to the 1985 year did not extinguish the assessment for the 1985 year. Id. at 89. See also Wilkes, 946 F.2d at 1152. Thus, the Service was entitled to collect the unpaid portion of the original assessment for the 1985 year.

Likewise, the misapplication of the requesting spouse's overpayment to the election year liability did not extinguish that liability. When the Service makes a "clerical error" in managing the taxpayer's account, the Service may correct its error as long as the correction of that error does not prejudice the taxpayer. It is undisputed that if the Service refunded the overpayment to the requesting spouse under I.R.C. § 6402(a) prior to the erroneous offset, neither the requesting spouse nor the nonrequesting spouse would be entitled to a credit against the election year liability or that the Service would be limited to the erroneous refund procedures to recover the amount refunded to the requesting spouse. Since the application of the overpayment to the election year resulted from a clerical error, once that error is corrected, the Service should be able to collect the tax administratively as if the offset had never taken place.

HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[redacted]

As always, we appreciate the opportunity to assist you and hope that the advice provided herein is helpful. If you have any questions or comments regarding this matter, please contact Inga Plucinski at (202) 622-3620.

Attachments (3)

cc: Chief Counsel
Chief Operations Officers
Counsel to National Taxpayer Advocate
Associate Chief Counsel (Domestic)
Assistant Chief Counsel (Field Service)

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

ATTACHMENT 1

December 28, 1999

MEMORANDUM FOR JACK HOLSTEIN
DIRECTOR, INNOCENT SPOUSE PROGRAM

FROM: Daniel J. Wiles
Deputy Associate Chief Counsel (Domestic)

SUBJECT: Offsets after Filing of Innocent Spouse Claims

You requested advice whether it was permissible to modify and correct the taxpayer's account so as to provide a refund with respect to an overpaid year when an innocent spouse claim with respect to an underpaid year was pending administrative consideration. After due consideration, we believe such action is permissible under the doctrine of correction of a clerical error. [redacted]

FACTS

At the time a taxpayer elects the relief provisions of I.R.C. § 6015 (b) or (c), certain collection actions are prohibited with respect to the liability as to which the election is filed. I.R.C. § 6015(e)(1)(B)(i). These prohibited collection actions do not include offsetting overpayments from other tax years, and such credits may legally be applied to the unpaid liability as to which the election is filed [hereafter referred to as "unpaid" or "election" year]. Nevertheless, such offsets are discretionary with the Service, I.R.C. § 6402(a), and the Service has made an administrative policy decision to exercise that discretion not to offset refunds if they would be applied to the year for which an innocent spouse election is made.[1] This policy was set forth

[1] This policy decision is particularly beneficial to the innocent spouse in the event relief is granted. The bulk of innocent spouse relief, if granted, is granted on the basis of qualification under § 6015(c) or (f). No refunds are allowed under § 6015(c) and the only refunds which can be made under 6015(f) are those paid under

in communications sent to all innocent spouse coordinators on May 5, 1999 and is being made permanent by formal action of the Innocent Spouse Program Manager. This noncrediting action is accomplished by marking the year for which the election is made with a transaction code 470, closing code 90 (except for cases in status 26). This code generates a "W-" freeze, reflects that there is a taxpayer claim pending, prevents notices from being generated and prevents offsets into the account. Thus, if an overpayment were reported with respect to another tax year, that overpayment would either be refunded to the taxpayer, or credited to a year for which the election had not been filed.[2] This code is placed on the module at the initial processing of the request for relief; therefore it should prevent credits from being applied to this unpaid year.

However, the code which is placed on the module has a maximum life of 26 cycles, and must be renewed, i.e., re-input at the appropriate time, to prevent later offsets. A substantial part of the current innocent spouse inventory is, or shortly will become, older than 26 cycles. Experience tells us that in a predictable number of cases, because of mistake, inadvertence, or inexperience of the employee, the code will not be timely re-input. In addition, it is possible that not all accounts have been initially input with this code. In those situations, the computer program will automatically take any overpayments from other years and apply them to the unpaid liability for the election year. If this occurs, as noted above, the innocent spouse rules may not permit the amount to be refunded from the election year account. See footnote 1. This problem is particularly troublesome given the upcoming filing season, during which overpayments will be generated from originally filed returns. In a number of these cases, the taxpayer will be financially dependent on receiving that refund, and hardships could be caused by application of that refund to the innocent spouse election year.

DISCUSSION

Most legally permissible actions of the Service Centers have legal ramifications from the moment the action occurs, and generally those legal effects cannot be avoided by simply "undoing" the action; that is, the Service may lack the authority to change its original action. Thus, for example, while it is within the Service's discretion whether to make an assessment of tax, once that assessment is properly made, it can be abated only under the conditions provided in I.R.C. § 6404. While

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installment agreements. See § 6015(e)(3)(A) and Notice 98-61.

[2] This code also prevents offsets of refunds that are generated by overpayments of the nonrequesting spouse. However, those refunds are nevertheless frozen and later applied to the outstanding liability once the innocent spouse issue is determined.

the Service may decide that it does not desire to file a tax lien against a taxpayer's property, once the lien is filed, it may be released or withdrawn only under the conditions provided in § 6323(j).[3] A nonstatutory "common law" exception to these prohibitions of correcting or changing legal actions of the Service has emerged under the case law and is referred to as the "clerical error" exception. Succinctly stated, whenever an action occurs because of mistake of fact or bookkeeping error, that mistake can be corrected, so long as this does not prejudice the taxpayer, Crompton-Richmond Co. v. United States, 311 F.Supp. 1184 (S.D.N.Y. 1970). Stated otherwise,

> ... [T]he government was not bound by some action by one of its officers resulting from a mistake of fact, which when such action was corrected, left the whole matter in such a situation that the party complaining had received no injury and had been done no injustice.

Kroyer v. United States, 55 F.2d 495 (Ct. Cls. 1932). At least one other court has come to the same result by deeming the mistaken action as not being what it purported to be (in that case an abated assessment), which essentially permitted the correction to occur. Matter of Bugge, 99 F.3d 740 (5th Cir. 1996).

The Service, under some circumstances, has adopted the rationale of clerical error corrections. There are, however, limitations and risks to following this line of reasoning. First, the parameters of "clerical errors" are not well defined. The case law does distinguish between an action which was taken pursuant to a judgment as to the substantive tax liability (not a clerical error) and mechanical or ministerial (i.e, nondiscretionary) errors; however, it cannot be stated with confidence when an error, not involving a substantive determination of liability, can be said to be wholly "clerical" in nature.

Second, the case law has arisen from cases significantly different from the issue here. In earlier cases, the mistake caused an erroneous abatement of a liability which was desired to be "unabated" by the Service but not the taxpayer. The question in these cases was whether the Service could return the assessment liability to where it had been before the error. Here, the error causes no changes to an assessment, but only to application of funds to that assessment. No assessment is abated.

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[3] It is to be noted that the circumstances under which a lien may be withdrawn were expanded at the Service's request precisely because it was felt that the prior law did not permit withdrawal of liens when the original filing was legal but unwise under the circumstances. Pub. Law 104-168, § 501(a).

Third, those cases dealt with situations where the erroneous action was clearly contrary to law. The correction brought the situation back into compliance with the law. In the instant situation, the offset is discretionary with the Commissioner; either offsetting or nonoffsetting would be perfectly legal. Thus, the correction here is not of a legally improper action.

Whether the clerical error doctrine applies depends on the specific facts of a situation; nevertheless, we are confident that in the case at hand, the reversal of the errors of application of the overpayment under the specific facts present here is within the parameters of the clerical error doctrine. We therefore conclude that reversing the offset by transferring the overpaid amount back to the overpayment year account is within the parameters and may be legally accomplished as the correction of a clerical error.

While the situation here is distinguishable from the fact situations of the case law, perhaps a stronger argument could be made here for correcting the clerical error. In the earlier cases, the taxpayer did not seek the correction of the error; rather the taxpayer opposed the correction. Nevertheless, the courts found that the correction could be made in that it did not prejudice the taxpayer (the result was as it would have been but for the clerical error). Here, the taxpayer will desire and request that the error be corrected. Thus, there is even less argument here that the taxpayer might be prejudiced.[4] Finally, while we recognize that the error we are correcting did not amount to an illegal act, it is one that is plainly contrary to clear nonjudgmental administrative procedures of the Service. Thus, we believe it logically may fall within the clerical error correction process.

We conclude therefore that reversing the offset by transferring the overpaid amount back to the overpayment year account is within the parameters and may be legally accomplished as the correction of a clerical error. It may then be refunded to the taxpayer or otherwise credited as permitted by § 6402.

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[4] It is conceivable, of course, that the nonpaying (and nonrequesting) spouse may claim some prejudice. After all, if the offset credit remains in the joint account, it reduces that nonrequesting spouses' joint liability notwithstanding that it was not paid by him. Reversal of that credit leaves the joint liability unreduced by the payment by the other spouse. However, because the nonrequesting spouse would have no cause to complain if the offset originally was prevented from occurring, we do not believe that the nonrequesting spouse will prevail in showing prejudice under the case law of clerical error. Implicitly, avoidance of an unwarranted windfall is not considered to be the requisite prejudice. While we recognize some risk here, it is probably a risk worth taking in order to alleviate the problem caused to the requesting spouse by not correcting the error.

RECOMMENDATION

[redacted] the courts are in agreement that a taxpayer's payment tendered in satisfaction of a tax assessment extinguishes the assessment to the extent of the payment. See generally Bilzerian v. United States, 86 F.3d 1067 (11th Cir. 1996), acq. in result, 1998 AOD LEXIS 8; Clark v. United States, 63 F.3d 83 (1st Cir. 1995); O'Bryant v. United States, 49 F.3d 340 (7th Cir. 1995). The Service, thus, may not take administrative collection action on a previously paid tax assessment, even if the Service inadvertently refunds a portion of the taxpayer's payment back to the taxpayer. Stanley v. United States, 35 Fed. Cl. 493 (1996); Rodriguez v. United States, 629 F. Supp. 333 (N.D. Ill. 1986). While the Service has now accepted the result of these cases, see Bilzerian AOD[redacted][5]

[redacted]

cc: Counsel to National Taxpayer Advocate
Deputy Assistant Chief Counsel (IT&A)
Assistant Chief Counsel (General Litigation)
Associate Chief Counsel (Domestic)

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[5] Service position remains that not every credit to the taxpayer's account constitutes a payment in satisfaction of the original assessment. A payment and/or credit satisfies only the tax to which it is properly applied. Clark, 63 F.3d at 89 (an assessment is not extinguished by the Service's error in applying the payment to the incorrect tax period). Thus, where, as here, neither the Service nor the taxpayer intends the overpayment to be offset to the election year, we would contend that no "satisfaction" or "extinguishment" can occur and the taxpayer continues to be liable for the unpaid tax.