


GENERAL LITIGATION BULLETIN

Department of the Treasury

Office of Chief Counsel

Internal Revenue Service

MORE THAN MERE NONPAYMENT **Eleventh Circuit Partially Overturns Haas**

The Eleventh Circuit, in an *en banc* rehearing in **Griffith v. United States, 206 F.3d 1389 (11th Cir. 2000)**, partially overturned its earlier decision of In re Haas, 48 F.3d 1153 (11th Cir. 1994), now holding that B.C. § 523(a)(1)(C) renders nondischargeable tax debts where the debtor engaged in affirmative acts constituting a willful attempt to evade or defeat payment of taxes. Previously, this circuit held that section 523(a)(1)(C) applied only to attempts to evade or defeat assessment of taxes, and that nonpayment, however egregious, was not a sufficient ground to find taxes nondischargeable in bankruptcy.

The debtor Griffith, owner of several interrelated adult entertainment “S” corporations, was found by the Tax Court to have underpaid his taxes by about two million dollars. However, the Tax Court did not impose fraud penalties, finding the Government did not meet the clear and convincing evidence standard. Less than a month after the Tax Court’s decision, the debtor formed a new corporation with his live-in girlfriend as sole shareholder. Eight months later, the debtor married his girlfriend, and in a prenuptial agreement transferred all assets from the “S” corporations to the new corporation or to himself and his bride as tenants by the entireties. Later, the debtor filed for Chapter 7 bankruptcy. Before the bankruptcy court, the Government successfully argued under B.C. § 523(a)(1)(C) that the tax debts were nondischargeable. On appeal, the debtor argued under the just-entered Haas decision that his taxes were dischargeable because the government had not proven that he willfully attempted to evade payment of the taxes. The district court disagreed. Distinguishing Haas, the district court found the debtor had done more than simple nonpayment of taxes.

Reversing the lower courts in its first decision, the Eleventh Circuit panel discharged the debtor from his tax debts. The appellate panel, saying it was bound by Haas, observed that section 523(a)(1)(c) contains both a mens rea requirement (“willfulness”) and a conduct requirement (“attempting to evade or defeat such tax”). Addressing the conduct requirement, Haas concluded that section 523(a)(1)(C) applies only to conduct constituting evasion of the *assessment* of a tax, so it does not apply to conduct that involves evasion of the *payment* of a tax. Haas relied on the omission of the phrase “or the payment thereof” from section 523(a)(1)(C), in contrast to several sections of the I.R.C. where the applicable language reads essentially that the taxpayer “willfully attempts to evade or defeat any such tax or the payment thereof.” The court in Haas felt Congress must have intentionally omitted “or the payment thereof”, and so limited the exception to discharge in section 523(a)(1)(C) only to those cases where actions taken by the debtor affected the assessment of the tax. This, the Haas court felt, comported with the Congressional intent to permit the debtor a “fresh start.”

Although finding Haas to be binding precedent, the panel was troubled by its application to a debtor who fraudulently transferred assets to avoid the payment of his tax debts. The appeals court noted that the Tenth Circuit, in Dalton v. IRS, 77 F.3d 1297 (10th Cir. 1996), also had been faced with a debtor evading the payment rather than the assessment of taxes. The Tenth Circuit rejected the broad holding of Haas, finding instead that the “in any manner” language in section 523(a)(1)(C), coupled with the stated purpose of bankruptcy to relieve only “honest” debtors, evidenced Congress’ intention to make a tax nondischargeable when the debtor attempts to evade the payment or collection of tax. Because it believed the phrase “or the payment thereof” was unnecessarily emphasized, causing Haas to be in conflict with other circuits, the Eleventh Circuit panel urged en banc reconsideration of its decision to narrow the scope of Haas.

On rehearing, the full Eleventh Circuit agreed that its holding in Haas was too broad. Examining section 523(a)(1)(C) in light of the canons of statutory construction, the appeals court found its earlier interpretation of the statute, as set out in Haas, to be plausible but incorrect. The more reasonable interpretation is that section 523(a)(1)(C) renders nondischargeable tax debts where the debtor engaged in affirmative acts seeking to evade or defeat collection of taxes. This interpretation, the court found, best balances Congressional intent to afford the honest debtor a “fresh start” while avoiding the creation of a tax evasion device. The court also found that its new interpretation better integrates the language of sections 523(a)(1)(B) and (C).

Applying this new interpretation to the facts of the case, the Eleventh Circuit found the lower court’s determination that the debtor Griffith committed fraud in his transfer of property not clearly erroneous. According to the court, Griffith (1) had a duty under the law to pay taxes; (2) knew he had that duty and (3) voluntarily and intentionally violated that duty. Therefore, the debtor’s tax debts were nondischargeable.

The Eleventh Circuit did reaffirm its first holding from Haas, that mere nonpayment of taxes, without more, is insufficient to establish the exception of section 523(a)(1)(C).

However, where the debtor engages in affirmative acts constituting a willful attempt to evade or defeat the payment of taxes, those taxes will be nondischargeable.

BANKRUPTCY CODE CASES: Exceptions to Discharge (§ 523)

CASES

1. **BANKRUPTCY CODE CASES: Automatic Stay: Creation, Perfection or Enforcement of Liens Against Property of Debtor or Estate**
In re McGhee, 2000 Bankr. LEXIS 232 (Bankr. E.D. Ky. Feb. 9, 2000) - Debtor transferred real estate to his sons without consideration. The Service then filed a Notice of Federal Tax Lien against the debtor, whereupon the debtor filed for Chapter 7 bankruptcy. During the bankruptcy, the trustee obtained judgment avoiding the transfers, then filed an action to have the Service's lien removed. The trustee argued that the automatic stay prevented attachment of the tax lien to the property when it became property of the estate. The court, however, found that the Service's lien was unaffected by the debtor's transfer. Since the lien was in existence on the property prior to the bankruptcy filing, it was unaffected by the resulting stay.

2. **BANKRUPTCY CODE CASES: Exceptions to Discharge**
Rinker v. United States, 85 AFTR2d ¶ 2000-577 (April 11, 2000)(unpublished) - As a condition of probation, taxpayer was ordered to file returns and pay all taxes. Instead, taxpayer filed Chapter 7 bankruptcy, arguing that the discharge included his tax liabilities. The Eleventh Circuit, in an unpublished opinion relying on Kelly v. Robinson, 479 U.S. 36, 46 (1986), held that any condition imposed as part of a criminal sentence is nondischargeable.

3. **BANKRUPTCY CODE CASES: Interest: Nondischargeable**
In re Cousins, 2000 U.S. App. LEXIS 6954 (1st Cir. April 18, 2000) - Postpetition interest on prepetition, nondischargeable tax liabilities is nondischargeable. The taxpayers filed Chapter 12 bankruptcy, had their plan confirmed without objection, and fully paid their prepetition tax liabilities through the plan. Following discharge, the Service demanded postpetition interest on the taxes paid. The First Circuit held that although the estate may not be liable for the interest debt under B.C. § 1222(a)(2) (which excludes postpetition interest from the plan), under Bruning v. United States, 376 U.S. 358 (1964) the debtor remains liable.

4. **BANKRUPTCY CODE CASES: Proofs of Claim: Time for Filing**
In re Gardenhire, 2000 Bankr. LEXIS 6857 (April 17, 2000) - The 180 day period for the Service to file a proof of claim in bankruptcy cannot be extended by equitable tolling. The taxpayers filed Chapter 13 bankruptcy on September 24, 1996. Due to a clerical error, a notice of dismissal of the case was mailed December 5, 1996. On February 22, 1997, an order reinstating the case was mailed, and the Service filed its proof of claim on March 20, 1997 (191 days after the bankruptcy petition was filed). The Ninth Circuit found B.C. § 502(b)(9) and Fed. R. Bankr. P. 3002(c) & 9006(b)(3) make the 180 day filing deadline absolute unless the Service, within the 180 day period, requests an extension. Equitable tolling cannot be used to circumvent the law, said the court.

5. **DAMAGES, SUITS FOR: Against the U.S.: Unauthorized Collection (§ 7433) United States v. Marsh, 2000 U.S. Dist. LEXIS 3342 (D. Haw. March 2, 2000)** - Taxpayer counterclaimed for damages in Government's suit to reduce tax liens to judgment. The court first found that the taxpayer's allegation (that levies by the Service in 1996 were not properly signed) was barred by the statute of limitations in I.R.C. § 7433(d)(3), because the counterclaim was not brought until 1999. The court also found that no a valid cause of action could be based on improperly signed levies, since the signature requirement was an internal policy, not required by statute or regulation. Next, the court found the statute of limitations was not tolled while the taxpayer exhausted administrative remedies, nor would it be equitably tolled since the taxpayer was not induced or tricked by the United States into allowing the deadline to pass. Finally, the court found proper the Government's continuous levy of more than 15% of the taxpayer's retirement benefits under section 6331(h).

6. **INNOCENT SPOUSE Milne v. United States, 2000 U.S. Dist. LEXIS 4825 (W.D. Wash. Feb. 24, 2000)** - As part of a criminal plea agreement, couple transferred their property to a trust. The trust was to liquidate the property, pay restitution to the victims, pay a monthly stipend to the couple, and pay any remainder to the couple. The Service filed a tax lien against the trust, which then paid half the proceeds from the sale of a parcel of real estate towards the outstanding taxes. After this, the wife was granted innocent spouse relief. She filed for a refund, but was administratively denied, so filed suit. The court granted her one-half the proceeds paid to the Service, finding that although the real estate was transferred to the trust, she retained a beneficiary's interest in the property both as to the monthly payments and as to the remainder. Further, the property retained its character as community property even after transfer to the trust, so the wife was entitled to a refund for her one-half interest in the community property proceeds which had been received by the Service.

7. **INNOCENT SPOUSE Wiksell v. Commissioner, 2000 U.S. App. LEXIS 5857 (9th Cir. March 28, 2000)(unpublished)**- Taxpayer is denied innocent spouse relief because she knew of the items of income that were unreported on the joint tax returns. The Ninth Circuit disagreed that the "actual knowledge" requirement of I.R.C. § 6015(c)(3)(C) meant that the taxpayer had to understand the tax consequences of the unreported income. The court also held that the fact that the taxpayer may have been exposed to abuse and duress by her spouse did not automatically entitle her to innocent spouse relief.

8. **LIENS: Priority Over Assignee: Assignment as Security Interest David v. Katz, 83 F.Supp.2d 736 (E.D. La. 2000)** - Creditor obtained assignment of beneficiary's interest in trust prior to filing of federal tax liens. The Government argued that the assignee's interest was inchoate, but the court found that the

interest transferred by the assignment was not the property held by the trust, but rather the beneficiary's interest in the trust itself. Since that interest was choate when the assignment was made, the creditor's interest had priority over the Government's.

9. **LIENS: Priority Over Mortgages: Refinancing**
Contimortgage Corp. v. United States, 2000 U.S. Dist. LEXIS 3998 (D. Minn. March 2, 2000) - In 1991, taxpayers mortgaged their property. In 1995, taxpayers refinanced. The new mortgage company had title work performed on February 6, April 24 and May 2, 1995. On May 4, the Government recorded Notices of Federal Tax Lien. On May 9, the old mortgage was paid off as the refinancing was completed. The court found applicable the doctrine of equitable subordination, where someone who pays off an encumbrance assumes the same priority position as the holder of the previous encumbrance. To find otherwise, the court held, would result in a windfall for the Government. However, the court also found that, before equitable subrogation could be used in this case, the factual matter of whether the mortgage company committed an excusable mistake of fact in failing to discover the existence of the federal tax liens, would need to be explored at trial.
10. **LIENS: Removal: Release: Reinstatement by Revocation**
United States v. Reid, 2000 U.S. Dist. LEXIS 5106 (S.D. Ga. March 21, 2000) - Through clerical error, the Government filed certificates releasing tax liens and wrote off taxes. Upon discovering its error, the Government filed certificates of revocation and reversed the credits on the taxpayer's account. The court found that, by filing suit within the ten year period of I.R.C. § 6325(f)(2), the period of limitation for collecting taxes was tolled. When the Government mailed notices of revocation, it timely reinstated the tax liens. Further, the court held that the insertion of erroneous credits, reducing the taxpayer's balance to zero, did not eliminate the underlying assessment.
11. **PROPERTY SUBJECT TO COLLECTION: Trusts**
United States v. Stolle, 2000 U.S. Dist. LEXIS 5454 (C.D. Cal. February 16, 2000) - Tax lien can attach to community property that is held on behalf of an individual taxpayer and his wife by a revocable trust, and the property may be used to satisfy the tax debts of the individual. Taxpayer and his wife held real estate as community property before transferring it into a revocable trust. The court held that because the taxpayer continued to have an interest in the property even after the transfer, the real estate was subject to the federal tax liens even after the taxpayer's death. Nor do the innocent spouse provisions of I.R.C. § 6015(b) protect community property from collection.
12. **TAX RETURN PREPARERS**
TAX SYSTEMS MODERNIZATION: Electronic Filing of Tax Returns
Sabat v. IRS Electronic File Program, 2000 U.S. Dist. LEXIS 3974 (W.D. Pa. March 16, 2000) - Taxpayer filed suit after being kicked out of the Service's

Electronic tax return filing program (ELF), challenging the Service's determination that the taxpayer's multiple criminal convictions constituted "disreputable conduct" under the ELF rules. The court upheld the denial of participation, finding the taxpayer could not rely on the definition of "disreputable conduct" in 31 C.F.R. § 10.51 (governing practice before the Service), as section is inapplicable to ELF applicants. Further, the court found the taxpayer had no constitutional right to participate in the ELF program, and even if he did, the Service's administrative appeals process was sufficient to satisfy due process.

13. TRUST FUND TAXES: Collection

Remington v. United States, 2000 U.S. App. LEXIS 6727 (5th Cir. April 13, 2000)

- Taxpayer, a general partner, argued that the Service was limited to pursuing responsible persons under I.R.C. § 6672(a), and could not avail itself of state law remedies. The Fifth Circuit disagreed, and held that the Service was entitled to hold the general partner jointly and severally liable for all debts and obligations of the partnership, including unpaid taxes, under state law.

CHIEF COUNSEL ADVICE

Fraudulent Returns

March 26, 1999

CC:EL:GL:Br3
TL-N-5854-98
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MEMORANDUM FOR SOUTH TEXAS DISTRICT COUNSEL

FROM: Lawrence H. Schattner
Chief, Branch 3 (General Litigation)

SUBJECT: Refund Schemes – Prisoner Returns

This responds to your memorandum dated September 15, 1998, which you directed to the Deputy Associate Chief Counsel (Domestic) and which was subsequently referred to our office for a response. This also responds to questions posed in a memorandum to you dated August 14, 1998, from the Director of the Austin Service Center. This document is not to be cited as precedent.

ISSUES:

- (1) Can overstatement of income tax prepayment credits on an individual income tax return (or claim for refund or credit) be considered in a deficiency determination?
- (2) Can a fraudulent Form W-2 be considered a fraudulent return? Does I.R.C. § 6501(c)(1) apply to a return based on a false Form W-2? Must the civil fraud penalty be assessed, per IRM 121.2.5.6 for the unlimited assessment period of section 6501(c)(1) to apply?
- (3) Does the period of limitations for making an assessment set forth in I.R.C. § 6501(a) and the unlimited period in section 6501(c)(1) apply to assessments of overstated prepayment credits made under section 6201(a)(3)?

(4) Can reversal of income tax prepayment credit, on the ground that the credit is overstated and does not exist, be considered an assessment under section 6201(a)(3)?

(5) What should be done with the frozen refund?

(6) What must be shown "at a minimum" in order to assert fraud and keep the statute open?

CONCLUSIONS:

(1) An overstatement of income tax prepayment credits on an income tax return cannot be considered in the determination of a deficiency.

(2) A Form W-2 is an information return, separate and distinct from the income tax return, Form 1040. Thus, a fraudulent Form W-2 does not constitute a fraudulent income tax return. The section 6501(c)(1) limitations period may apply to a return based on a false Form W-2 if the Service can show that the income tax return with respect to which the assessment is being made is false or fraudulent with the intent to evade tax. The Service is not required to assert or assess the civil fraud penalty in order for the unlimited period of section 6501(c)(1) to apply.

(3) Assessments of the amount of overstated income tax prepayment credits under section 6201(a)(3) is governed by the applicable period of section 6501, including section 6501(c)(1) if the overstatement of the credit reported on the return is false or fraudulent with intent to evade the tax.

(4) A transaction shown on the taxpayer's account as a reversal of income tax prepayment credit is not a section 6201(a)(3) assessment because a reversal does not comply with the requirements for assessment.

(5) Where the Service is successful in freezing the claimed refund before it is paid to the taxpayer, the Service should adjust the taxpayer's account by reversing the overstated prepayment credit. Neither the assessment nor deficiency procedures are necessary and the overstated credit can simply be reversed. The Service should notify taxpayer of this action by following the refund procedures and issuing a notice of claim disallowance because the taxpayer's assertion of the credit resulting in a claimed overpayment is a claim for refund. Under the provisions of section 6532(a)(1), the taxpayer must file a refund suit within two years from the date the notice was mailed. Once the two year period expires, the Service could move the frozen refunds to the excess collections file since these amounts would then be considered time barred claims for refund.

After the overstated credit is reversed, the Service should abate the assessment under section 6404(a)(1). Since it has been determined that there are no wages and no tax liability, the entire assessment is excessive in amount. It may be appropriate to advise the taxpayer in the notice of claim disallowance that the Service will also be abating the

reported tax liability to dispel any fears that the Service may attempt to collect those amounts.

(6) Since we recommend that the Service simply reverse the overstated credit where no refund is paid to the taxpayer rather than making an assessment under section 6201(a)(3), it is unnecessary to determine what must be shown to assert fraudulent conduct for purposes of the statute of limitations under section 6501(c)(1).

FACTS:

The questions that were submitted involved the following general scenario. An individual files an individual income tax return, Form 1040EZ. The return reports taxable income from employment, income tax, income tax prepayment credit for withholding shown on an attached W-2, and overpayment of income tax for which refund is claimed.

The Service identifies the return under the Questionable Refund Program, designed to detect and stop fraudulent or questionable claims for refund. Because the return is apparently complete in required detail, the return is processed so that the taxpayer's account shows filing of the return, assessment of reported income tax, and posting of reported income tax prepayment credits.¹ In the factual scenario you presented, the Service was able to freeze the account so that a refund or credit was not made.

The Service investigates the W-2 information and discovers that the taxpayer was not employed by the identified employer for the period covered by the W-2, was incarcerated for most or all of the period covered by the W-2, was not paid income by the identified employer, did not have any amount withheld by the identified employer, and was not issued a W-2 by the employer identified on the W-2. Thus, the employment, income and withholding information reported on the W-2 are false.

Since the taxpayer did not earn any income at all, he is not liable for any tax liability reported on the return. Thus, the income tax assessment based on the liability reported on the return is excessive.

Since the withholding items of W-2 information are false, the withholding credits reported on the income tax return are false. The return reports more payment credits and, thus, claims an overpayment and a refund to which the taxpayer is not entitled. The basic assessment period of section 6501(a) has now expired.

LAW AND ANALYSIS:

¹ A return, although it may contain false or fraudulent information, must be processed as a return for purposes of I.R.C. § 6012 where completed in required detail and signed under penalties of perjury. See Zellerbach Paper Co. v. Helvering, 293 U.S. 172 (1934), and Badaracco v. Commissioner, 464 U.S. 386, 396-397 (1984).

(1) Overstatement on an income tax return (or claim for refund or credit) of income tax prepayment credit (for income tax withholding or estimated income tax payment) cannot be considered in the determination of a deficiency. I.R.C. § 6211(b)(1), and the legislative history to section 6201(a)(3), preclude consideration of income tax prepayment credit or its overstatement in the determination of a deficiency. See, S. Rep. No. 1622, 83d Cong., 2d Sess., at page 572 (1954); H. Rep. No. 1337, 83d Cong., 2d Sess., at page A404 (1954); Attachment, dated May 18, 1972, to G.C.M. 34508. The congressional committee reports which accompanied section 6201(a)(3) when it was originally enacted in the Internal Revenue Code of 1954 indicate that the Service already had the authority to administratively reverse overstated withholding credits except when the Service had already made a refund or credit. Id. This legislative history indicates that the deficiency procedures were not intended to apply to an overstatement of prepayment credits since the Service had the authority to reverse the credits before the enactment of section 6201(a)(3) without following the deficiency procedures. Id. Moreover, the definition of a deficiency explicitly does not consider the payment of estimated taxes or withholding of taxes in the calculation. Section 6211(b)(1) provides in part: “The tax imposed by Subtitle A and the tax shown on the return shall both be determined without regard to payment on account of estimated tax, without regard to the credit under section 31...” The amounts withheld from wages are credits under section 31 and estimated taxes are credits under section 6315. Thus, the amount of the overstatement is immediately assessable under section 6201(a)(3) in the same manner as a mathematical or clerical error under I.R.C. § 6213(b)(2), except that the taxpayer cannot force the use of the deficiency procedures.

(2) Section 6501(c)(1) provides that in the case of a fraudulent return with the intent to evade tax, the tax may be assessed at any time. The “return” in this provision is the return on which the tax liability is reported and with respect to which the assessment is made. A Form W-2 is an information return on which no tax is reported and with respect to which the Service makes no assessment. The Form W-2 is separate and distinct from the income tax return, Form 1040. Thus, a fraudulent Form W-2 does not constitute a fraudulent income tax return and the unlimited limitations period under section 6501(c)(1) would not apply merely because the Form W-2 is fraudulent. On the other hand, the (c)(1) limitations period may apply to an income tax return based on a false Form W-2 if the Service can show that the income tax return is false or fraudulent with intent to evade the tax.

The addition to tax for fraud is not required to be assessed before the limitations period under section 6501(c)(1) is triggered. Statute of limitations sought to be applied to bar rights of the government must be strictly construed in favor of the government. Badaracco v. Commissioner, 464 U.S. 386 (1984). In Badaracco, the Supreme Court recognized that filing a fraudulent return had distinct implications for criminal prosecution, for additions to tax for fraud and for the assessment period set out in section 6501(c)(1). Id. At 394. The Supreme Court concluded that the plain and unambiguous language of section 6501(c)(1) permits assessment at any time where the taxpayer files “a false or fraudulent return.” Id. At 396. This section is separate and distinct from the provisions for additions to tax for fraud and makes no reference to any requirement that an addition to tax for fraud must be

asserted or assessed as a precondition to its application. Section 6501(c)(1) by its terms simply does not require a fraud penalty assertion or assessment for its application.

The purpose of IRM 121.2.5.6 is to give guidance on how to handle a case after it has been closed by the Examination Division. These instructions are premised on the supposition that an addition to tax for fraud has been asserted along with a proposed deficiency. Thus, if the addition to tax for fraud cannot be established by the government, then there could be no reliance on section 6501(c)(1).

(3) I.R.C. § 6201(a)(3) authorizes the Secretary to make assessments of the amount of an overstatement of income tax withholding credits. The authority in this subsection is included within the general authority under section 6201(a) to make assessments of taxes. It is our position that the placement of the assessment authority regarding overstated credits within the general assessment authority of section 6201(a) is indicative of Congressional intent that an assessment under (a)(3) is within the section 6201(a) term “taxes” and that a section 6201(a)(3) overstatement is assessed as a tax.

The Congressional intent that the amount assessed under section 6201(a)(3) is of a tax is also reflected in the legislative history, which provides:

There is also a material change from existing law in subsection (a)(3) of this section, relating to erroneous credits for prepayment of income tax (prepayment through credit for tax withheld at source and payments of estimated tax). Under this new paragraph refunds caused by erroneous payment credits may be recovered by assessment in the same manner as in the case of a mathematical error on the return. For example, assume a case in which the tax shown on the return is \$100, the claimed prepayment credit is \$125, and a refund of \$25 is made, and it is later determined that the prepayment credits should have been only \$70. Under existing law, \$30 (the tax shown on the return less the \$70 credit) can be immediately assessed as tax shown on the return which was not paid, but the remaining \$25 must be recovered by suit in court. Under the new provision, the entire \$55 can be assessed and collected.

Since an overstatement within section 6201(a)(3) is claimed on an income tax return, and since the government has the ability to match tax payments shown by W-2s and estimated tax vouchers, it appears likely that Congress intended that the assessment of section 6201(a)(3) overstatements be in the same manner as the tax reported on the return. See, also, Phillips v. Stoepler, 421 F.2d 105 (6th Cir. 1970) (section 6201(a)(3) assessment upheld where made within the section 6501(a) period).

We believe that the applicable assessment period of section 6501 applies to assessment under section 6201(a)(3) of an overstatement of income tax prepayment credit. Section 6501(a) applies to assessment of tax “imposed by this title” in respect of a return. It is our position that an assessment under section 6201(a)(3) is of a tax imposed by that section

in the amount of the overstatement of income tax prepayment credit claimed by the taxpayer on an income tax return (or claim for refund or credit). See, e.g., *Brister v. United States*, 35 Fed. Cl. 214, at fn. 12 (1996) (criticizing a rationale in *deRochemont v. United States*, 23 Cls. Ct. 80 (1991)).

We therefore conclude that section 6201(a)(3) imposes a tax and creates a tax liability which is immediately assessable. Since the amount assessable under subsection (a)(3) is treated as a tax imposed by Code, this assessment is governed by the statute of limitations under section 6501(a). See *Brister*, supra.

We also believe that the unlimited period of section 6501(c)(1) applies to a section 6201(a)(3) assessment where overstatement of income tax prepayment credit is false or fraudulent. In *Brister*, supra, the taxpayer reported overstated withholding credits on his returns and obtained refunds. The Service reversed the credits and made section 6201(a)(3) assessments for the amounts refunded. The assessments were collected by refund offsets. Although the reversals and assessments were performed outside the section 6501(a) three year period for assessment, the government asserted that the assessments were timely under the unlimited assessment period of section 6501(c)(1). The court agreed, finding that the government established that the returns were knowingly false. In discussing the intent to evade tax component of section 6501(c)(1), the court recognized that reversing the withholding credits would not actually cause plaintiff to pay additional income tax for the years at issue. Nonetheless, the court explained that plaintiff's actions affected the credit side of the debit and credit elements used to calculate net tax liability and the plaintiff, thus, evaded tax.

If the assessment periods set forth under section 6501(a) do not apply, an argument could be made that the period for making assessments under section 6201(a)(3) is unlimited (whether or not a claim to income tax prepayment credits is fraudulent). *Capozzi v. United States*, 980 F.2d 872, 874 (2d Cir. 1992). In *Capozzi*, the court of appeals had to determine the correct statute of limitations on the assessment period for I.R.C. § 6700 penalties for promotion of abusive tax shelters. The court of appeals held that there would be an unlimited statute of limitations on the assessment period where Congress does not clearly specify whether a limitation period applies to a particular provision. Id. at 875; see, also, *Mullikin v. United States*, 952 F.2d 920 (6th Cir. 1992) (unlimited statute of limitations on assessment furthers the interests of Congress in combating fraud relating to the filing of various tax documents). It appears to us that if section 6501 does not apply, then the rationale of *Capozzi* would since there is no other specific section of the Code that deals with making assessments pursuant to section 6201(a)(3). Contra, *deRochemont*, supra, but compare *Brister*, supra.

(4) A transaction shown on the taxpayer's account as a reversal of an income tax prepayment credit is not a section 6201(a)(3) assessment. The requirements for assessment, provided in Treas. Reg. § 301.6203-1, specify that an assessment must be recorded by a summary record of assessment (a Form 23C or RACS 006) signed by an assessment officer, and the date of such signing is the date of assessment. The Service

does not assess reversal of payment credits. The Secretary is authorized to make assessments of taxes and reversal of a payment credit does not impose a tax liability that is assessable under the Secretary's general assessment authority.

(5) As noted above, the taxpayer's return was processed as a valid return so that the taxpayer's account shows the filing of the return, assessment of the income tax reported on the return, and posting of the withholding credits claimed on the return. Subsequently, the return is identified as questionable and the amount claimed as a refund based on the claimed withholding credits is frozen before the refund is generated and paid to the taxpayer. The Service later determines that the taxpayer has not earned income and has not incurred a tax liability, and that no employer has incurred a withholding requirement (in fact, taxes were not withheld and paid over to the Service in respect of employment of this taxpayer).

The Service should adjust the taxpayer's account by reversing the claimed withholding credits. Since the taxpayer claimed a refund based on the withholding credits reported on the return, the refund procedures should be employed to notify the taxpayer of the claim disallowance. If a timely refund suit is not filed, the Service could move the frozen refunds to the excess collections file since these amounts would then be considered time barred claims for refund. The reversal of

the overstated credits are mere accounting adjustments and do not trigger the deficiency or assessment procedures. The legislative history of section 6201(a)(3) clearly indicates that the Service already possessed the authority to reverse overstated credits before it was granted the authority to assess these overstatements in (a)(3) and thus, it is our view the Service is not required to use its assessment authority if it chooses instead to simply reverse the overstated credits.

Once the Service reverses the overstated credit, the taxpayer's account still reflects an assessment of a tax which the taxpayer never incurred and will subject the taxpayer to collection activity unless the assessment is removed. The Service is authorized to abate assessments under section 6401(a)(1) that are excessive in amount. The entire assessment in this case is excessive in amount and therefore should be abated. We recommend that the taxpayer be notified that the assessment will be abated when the taxpayer is sent the notice of claim disallowance.

Alternatively, the Service could assess the entire amount of the overstated credit under section 6201(a)(3) and apply this assessment against the reported withholding credit. Under this provision, the mathematical error assessment procedures apply to allow a summary assessment. However, this assessment is exempted from the normal math error procedures which would otherwise require that the assessment be abated if protested by the taxpayer. However, in the case where no refund has been paid to the taxpayer, this procedure is cumbersome and unnecessary. Moreover, if the normal three year period for making an assessment under section 6501(a) has expired, the Service may be required to

show that the income tax return is false or fraudulent with intent to evade the tax in order to permit assessment under the unlimited period of section 6501(c)(1).

(6) Proof of knowingly false or fraudulent conduct is determined by the facts and circumstances of each case. While case law has given guidance concerning what would be an indicia of fraud, we do not think it appropriate to establish some sort of minimum demonstration test to cover all potential cases. In any event, a response to this question is unnecessary in light of our recommendation that the Service should reverse the overstated credits rather than making a section 6201(a)(3) assessment.

Erroneous Refunds - Offset

CC:EL:GL:Br2
TL-N-6170-99
UILN: 28.00.00-00

February 7, 2000

MEMORANDUM FOR ASSOCIATE DISTRICT COUNSEL
ROCKY MOUNTAIN DISTRICT

FROM: Joseph W. Clark
Acting Deputy Assistant Chief Counsel (General Litigation)

SUBJECT: Significant Service Center Advice: Offsets to Satisfy Erroneous
Refunds in Absence of Assessment or Judgement

This responds to your request for Significant Service Center advice, in connection with questions posed by the Ogden Service Center.

ISSUES

1. Can the Internal Revenue Service recover a nonrebate erroneous refund pursuant to its common-law right of offset.
2. If so, what is the applicable statute of limitations?

CONCLUSIONS

1. Yes. The Service may recover a nonrebate erroneous refund pursuant to the long established principle of offsetting mutual debts between mutual parties.
2. The applicable statute of limitations to recover a nonrebate erroneous refund is the two or the five year period set forth in I.R.C. § 6532(b).

FACTS

The Ogden Service Center has requested your assistance in reviewing a number of erroneous refund cases under Internal Revenue Manual 3.17.79.16.5.1.² In the process of reviewing these cases to determine whether the five year period of limitations applies, your office became aware that the majority of these refunds were being recouped under the common-law right of offset. You believe that the Service may not offset overpayments otherwise due to the taxpayer with respect to other tax years against an erroneous refund liability unless the Service either makes a new assessment or obtains a judgment for the erroneous refund. While we agree with you that the Service may not rely on Internal Revenue Code section 6402 to offset overpayments against unassessed erroneous refund liability, we are of the opinion that the Service may recoup nonrebate erroneous refunds under the common-law right of offset.

LAW & ANALYSIS

Erroneous refunds fall into one of two general categories. The first category consists of refunds which are “rebates” within the meaning of I.R.C. § 6211(b)(2).³ Rebate refunds occur when the Service reduces or abates the taxpayer’s liability on the basis that the correct tax liability is less than the amount previously assessed or reported by the taxpayer on the return. See Singleton v. United States, 128 F.3d 833, 836 n.11 (4th Cir. 1997); Clayton v. Commissioner, T.C. Memo 1997-327. The propriety of a rebate refund, therefore, depends on the correctness of the assessed tax. Id.

To recover a rebate erroneous refund, a new determination of the taxpayer’s tax liability, either administrative or judicial, must take place. If an administrative approach is taken, the Service will generally have to follow deficiency procedures⁴ and make a new or supplemental assessment within the applicable assessment period. I.R.C. §§ 6204, 6211 *et seq.*, and 6501. Once a new assessment is made, the Service will have 10 years from the date of the assessment to collect the tax. I.R.C. § 6502. Alternatively, the Service may bring either a suit to reduce the liability to judgment (brought within the assessment period) or an erroneous refund suit pursuant to section 7405 of the Internal Revenue Code (brought within the period of limitations set forth in section 6532(b)).

² IRM 3.17.79.16.5.1 requires the Service to coordinate with district counsel all cases where it appears that any part the erroneous refund “was induced by fraud of misrepresentation of a material fact.” I.R.C. § 6532(b).

³ Certain erroneous refunds, while not “rebates” within the meaning of section 6211(b)(2), are, nonetheless, assessable under the Code. E.g., I.R.C. § 6201(a)(3). Once the amount refunded is assessed, it can be collected in the same manner as a tax within the 10-year collection period.

⁴ Assessment of certain erroneous income tax prepayment credits (Category B refunds) made under the authority of I.R.C. § 6201(a)(3) is not subject to the deficiency procedures. Certain nondeficiency taxes would, likewise, not be subject to the restrictions placed on deficiencies. I.R.C. § 6211 *et seq.*

The second category of erroneous refunds consists of refunds which are not considered “rebates” within the meaning of section 6211(b)(2). See Lesinski v. Commissioner, T.C. Memo 1997-234; Groetzing v. Commissioner, 69 T.C. 309, 315 (1977). Because these erroneous refunds are not rebates, they are often referred to as “nonrebate erroneous refunds.” Nonrebate erroneous refunds occur not as a result of a redetermination of the taxpayer’s liability but rather as a result of an error committed in performing some function other than recomputing the tax liability, *i.e.*, misapplied payment, misdirected direct deposit, duplicate refund. O’Bryant v. United States, 49 F.3d 340, 342 (7th Cir. 1995); Clayton, *supra*. As such, these refunds generally do not affect the taxpayer’s tax liability and cannot be assessed under the Internal Revenue Code.

Because nonrebate erroneous refunds cannot be assessed in the same manner as rebate refunds, the remedies generally available to the Service to collect unpaid tax liabilities are not available to the Service to recover nonrebate erroneous refunds. The Service, however, has other remedies to recover amounts erroneously refunded out of the treasury. First, the Service may recover any erroneous refund by instituting an erroneous refund suit in accordance with I.R.C. § 7405. Stanley v. United States, 140 F.3d 1023 (Fed. Cir. 1998). In order to be timely, an erroneous refund suit must be filed within two (or five) years from the date the taxpayer received the erroneous refund. O’Gilvie v. United States, 519 U.S. 79 (1996); I.R.C. § 6532(b). The Service may solicit a voluntary repayment of the erroneous refund within two or five years from issuance of the erroneous refund. I.R.C. § 6532(b). Stanley, 140 F.3d at 1028 (Service has long used consensual dispute resolution in lieu of litigation). These, however, are not the only remedies the Service may use to recover a nonrebate erroneous refund. See Brookhurst v. United States, 931 F.2d 554, 556-57 (9th Cir. 1991) (government may use methods other than specific erroneous refund suit provision to recover erroneous refund). Accord O’Bryant, 49 F.3d at 343 n.4; Crocker First Nat’l Bank v. United States, 137 F. Supp. 573 (N.D. Cal. 1955).

The general authority to apply overpayments against outstanding tax liabilities can be found in I.R.C. § 6402(a). This section provides in relevant part as follows:

In case of an overpayment, the Secretary, within the applicable period of limitations, may credit the amount of such overpayment ... against any liability in respect of an internal revenue tax on the part of the person who made the overpayment....

I.R.C. § 6402(a). While the phrase “any liability in respect of an internal revenue tax” is not defined in the statute, it has long been the Service’s position that a tax liability, which could be enforced through normal assessment and collection procedures (*i.e.* a tax liability which has been assessed or for which a statutory notice of deficiency has been issued), is a prerequisite to making an offset under section 6402. See Treas. Reg. § 301.6402-1. Accordingly, unless the Service can assess the amount erroneously refunded (as in a case of a rebate refund), the Service may not use its statutory right of offset under I.R.C. § 6402 to recover the erroneous refund.

Section 6402(a), nonetheless, does not preclude an offset of an overpayment against a non-tax debt as long as an independent authority exists for the offset.⁵ Isbrandtsen Co. v. Johnson, 343 U.S. 779, 783 (1952) (“statutes which invade the common law... are to be read with a presumption favoring the retention of long established and familiar principles, except when statutory purpose to the contrary is evident”). It is a long established principle that the Government has the same common law right belonging to every creditor to set off monies owed by it to debts due it by the same debtor. United States v. Munsey Trust Co., 332 U.S. 234 (1947); Cherry Cotton Mills, Inc. v. United States, 325 U.S. 234 (1947); Crocker, *supra*. Additionally, the right to set off against non-tax debts due the Government has been expressly provided for by statute. See, e.g., 31 U.S.C. § 3711 (1999). Because liability resulting from a nonrebate erroneous refund is not a tax liability, see O’Bryant, *supra*, the statutory framework which governs collection of taxes is not frustrated by the use of common-law right of offset to recover this type of refund. See Chateaugay Corp. v. LTD Steel Co., 94 F.3d 772, 778-79 (2d Cir. 1996) and the cases cited therein.

While the most recent decision in this area contains language adverse to the Government, see Moran v. United States, 953 F. Supp. 354, 357 (N.D. Okl. 1996)⁶, we are of the opinion that the Service should continue to assert its rights under the common law. See Chateaugay, 94 F.3d at 778 (“there is no better proof of the existence of a common law right than its exercise, and acceptance by the courts”). We agree with the approach taken by the court in Crocker, *supra*. In that case, the Service erroneously refunded to the taxpayer interest on his refund for the 1942 tax year. A year later, the Service requested repayment of the erroneous interest. The taxpayer did not repay it. Subsequently, in 1948, the taxpayer filed a return for the year 1945 seeking a refund. The Service allowed the taxpayer’s claim but offset part of the 1945 overpayment against the 1942 erroneous refund liability.

Because the offset was accomplished more than two years after the erroneous interest payment was made to the taxpayer, the court ruled for the taxpayer. In relevant part, however, the court noted:

While the plaintiff does not concede that the payment by the Government of interest on the refund of 1942 taxes was in fact erroneous, it has chosen to rest its case on the contention that the offset in 1950 was not timely made. There is no limitations statute specifically fixing the time within which such offset may be made. There is, however, a statute, limiting to two years, the time within which the United States may sue to recover erroneous refund of

⁵ See O’Bryant v. United States, 49 F.3d 340, 345 (7th Cir. 1995) (there is a fundamental difference between a tax liability and a nonrebate erroneous refund).

⁶ Please note that in Moran the Service did not offset a tax overpayment against an erroneous refund liability but rather attempted to collect, via levy, an erroneous refund in reliance on the original, but previously paid, assessment. As such, the case is inapposite to the situation at hand.

taxes or erroneous payments of interest on refund. Since it is obvious that the offset claimed by the Commissioner must be the equivalent of a cause of action by the Government in a suit to recover the erroneous payment ... the time limitation for suit applies equally to the offset.

Crocker, 137 F. Supp at 574 (*citations omitted*).

In conclusion, we are of the opinion that as long as the Service is unable to assess nonrebate refunds, the Service may justifiably rely on the common law right of offset to recover these non-tax debts. The applicable statute of limitations for this remedy is the two or five year period set forth in I.R.C. § 6532(b). Although the taxpayer may voluntarily and knowingly waive this period, see United States v. National Steel Corp., 75 F.3d 1146 (7th Cir. 1996), the Service should not solicit such waivers for the sole purpose of offsetting the taxpayer's refunds to the erroneous refund liability. Waivers should be requested only in limited circumstances, such as where a taxpayer agrees to repay the erroneous refund but needs additional time. These waivers, however, should be short and have a specific end date (i.e. no open-ended extensions).

Reinstatement of Terminated Offer in Compromise

December 9, 1999

CC:EL:GL:Br2
GL-611465-98
UILC: 17.15.00-00

MEMORANDUM FOR DISTRICT COUNSEL,

FROM: Joseph W. Clark
Acting Chief, Branch 2 (General Litigation)

SUBJECT:

This memorandum responds to your request for advice dated July 15, 1999. This document is not to be cited as precedent.

ISSUE

Whether an offer in compromise which has been terminated by the Service due to a taxpayer's default can later be reinstated by the Service.

CONCLUSION

Once an offer in compromise has been terminated for default by the taxpayer, the Service lacks the authority to reinstate the agreement.

BACKGROUND

On Date A, the Service accepted two separate offers in compromise from Taxpayer X (“taxpayer”), one for the years Year 1 to Year 7 and one for the years Year 8 and Year 9. The earlier liabilities were incurred jointly with his deceased spouse. The taxpayer made timely payments of Amount A, as agreed. Each offer in compromise contained the standard language in which the taxpayer promised to comply with all provisions of the Internal Revenue Code relating to the filing of returns and payment of taxes for five years following acceptance of the offer. See Form 656, Offer in Compromise, Item 8(d).

The taxpayer’s Year 11 and Year 12 income tax returns were due to be filed August 15, Year 12 (as a result of an automatic extension), and April 15, Year 13, respectively. In October Year 14, the Service Center asked that the taxpayer’s failure to file those returns be investigated by the field. An Offer in Compromise (OIC) Specialist was assigned to the case. As was the practice in these kinds of cases, the OIC Specialist contacted the taxpayer in an attempt to secure the returns prior to declaring the compromise agreement to be in default.

On Date B, the OIC Specialist sent a letter to the taxpayer requesting the unfiled returns. The letter reminded the taxpayer that failing to file returns constituted default and asked that the taxpayer submit the returns by Date C, or contact the district immediately. No response was received. On Date D, the taxpayer was sent a letters stating that the compromise agreements had been terminated.⁷ On Date E, taxpayer’s current wife called to inquire about the status of the compromises and to promise that the returns were forthcoming. The OIC Specialist stated that the compromises would be reinstated if the returns were filed by Date F. The OIC Specialist then called the Service Center and was told that no action would be taken while they awaited receipt of the missing returns. Those returns were received by the OIC Specialist on Date G.

On Date H, the OIC Specialist sent the taxpayer a letter indicating that the compromise agreements had been reinstated. Subsequently the Service Center’s OIC Unit concluded that because termination letters had been sent, the compromises could not legally be reinstated. That conclusion was based upon advice previously given by this office. You

⁷ The Date D letters incorrectly stated that the compromise was being terminated for failure to return a refund for the Year 11 tax year, as was required by the compromise agreement. See Form 656, Offer in Compromise, Item 8(g). However, this error did not invalidate the termination. There is no question that the taxpayer received actual notice of the reasons the compromise was in default. Furthermore, under the terms of the compromise, the Service need not give notice to act on default of the agreement. See id. at Item 8(o). See also *United States v. Feinberg*, 372 F.2d 352, 358 (3d Cir. 1967) (stating that government is not required to issue “warning shot” before taking action on defaulted compromise agreement).

have asked that we reconsider the question of whether a terminated offer in compromise can be reinstated.

DISCUSSION

A compromise under section 7122 of the Internal Revenue Code (I.R.C. or "Code") is recognized as a contract. See United States v. Feinberg, 372 F.2d 352 (3d Cir. 1967); United States v. Lane, 303 F.2d 1 (5th Cir. 1962). As such, the compromise agreement is subject to judicial interpretation using generally accepted contract principles.

Your memorandum states that the present case requires an examination and application of the law of rescission of contracts. We do not agree that rescission is the issue. Rescission is defined broadly as canceling, nullifying or avoiding a contract. See, e.g., Black's Law Dictionary 1306 (6th ed. 1990). However, there is some disagreement as to the scope of that term in contract law. Some authorities use the term to describe only cases of mutual agreement to discharge the parties' obligations under the contract, see 5A Corbin on Contracts § 1236 (1964 & Supp. 1999); Woodruff v. McClellan, 622 P.2d 1268, 1269 (Wash. 1980), while others also apply the term to situations where the contract authorizes unilateral cancellation upon the occurrence of specific events. See 17A Am.Jur.2d Contracts §§ 539 & 565 *et seq.*⁸ On one point, however, all authorities appear to be in agreement: a rescission only takes place when a contract is undone from the beginning, placing both parties in the same position they would occupy had they never entered into the contract. See *id.* at § 539; 17A C.J.S. Contracts § 385(2); Dairyland Power Coop. v. United States, 27 Fed. Cl. 805, 813 (1993), *aff'd* 16 F.3d 1197 (Fed. Cir. 1994); Brannock v. Fletcher, 155 S.E.2d 532, 542 (N.C. 1967).

An offer in compromise can only be rescinded if there was a mutual mistake as to a material fact or there was a misrepresentation by one of the parties to the agreement. Treas. Reg. §301.7122-1T(d)(5); IRM 5.8.9.2(2). Action taken by the Service in response to a failure to meet the compliance provisions of Item 8(d) of Form 656 is not a rescission. The parties are not returned to their former positions, as they would be in a rescission. The Service, in response to the taxpayer's breach of the agreement, applies the funds remitted in compromise to the underlying tax liabilities and takes action to collect the balance administratively or through filing a suit. Service procedures term this action a "termination" of the agreement. See IRM 5.8.9.4(5)

⁸ In Nebco & Associates v. United States, 23 Cl. Ct. 635, 642 (1991), the Claims Court discussed the "confusion" regarding the use of the term rescission. That court distinguished between "rescission by agreement" and "rescission," which sometimes refers to a power of avoidance arising from fraud or mutual mistake. *Id.* Use of the term rescission to refer to a unilateral power to cancel a contract finds its roots in the concept that fraud or mistake supports a finding of "implied consent" by the other party. See Dooley v. Stillson, 128 A. 217 (R.I. 1928).

Upon breach of a contract, the non-breaching party may cease performance and sue for damages or seek other remedies allowed by law. See Stone Forest Indus., Inc. v. United States, 973 F.2d 1548, 1550 (Fed Cir. 1992). In the offer in compromise context, the agreement clearly spells out that the Service may, without notice to the taxpayer, take action to collect either the unpaid compromise amount or the full amount of the underlying liability. See Form 656, Item 8(o). Although no notice to the taxpayer is required before commencing action, notice is generally given in the form of a “termination letter.” This practice has the benefit of showing with certainty that the Service regards the agreement as terminated and establishes the date on which the termination takes effect. We conclude that the Service terminated the offers in compromise on Date D, as evidenced by the letters of that date sent to the taxpayer.

You cite the proposition that a rescinded contract can be reinstated by mutual agreement of the parties. The difference between rescission and termination of a contract in response to default illustrates why reinstatement is not such a simple matter in this case. As stated above, the parties to a rescinded contract are restored to their former positions. They are then free to reinstate the contract through an exchange of the same promises that formed consideration for the original contract. Such an act is indistinguishable from forming a new contract. In the context of termination of a defaulted contract, however, one party or another may have partially or fully performed under the contract. As such, the promise they receive from the other party in reviving the contract may be considered gratuitous—not supported by any consideration flowing in return. “A contract must be supported by consideration to be valid and legally enforceable.” 17 C.J.S. Contracts § 71. See Aviation Contractor Employees, Inc. v. United States, 945 F.2d 1568, 1574 (Fed. Cir. 1991).

In this case, the Service would revive the compromise agreement in return for current and future compliance with applicable provisions of the Internal Revenue Code, acts the taxpayer was already legally obligated to perform. A promise to perform on a pre-existing legal obligation cannot be consideration for a contract. See 17A Am.Jur.2d Contracts § 144. For offers in compromise, consideration is found in the potential for mutual concessions which exists after doubt as to liability or collectibility has been established. See Op. Att. Gen. 6, XIII-47-7138 (October 24, 1933). Such concessions form the bases for “compromise,” and these bases have been incorporated into the regulations delineating the authority of the Service to compromise tax liabilities. See Treas. Reg. §301.7122-1T(b)(2) & (3). See also Treas. Reg. §301.7122-1T(b)(4) (providing additional authority where compromise would promote effective tax administration). Thus, even if contract law would allow the compromise to be reinstated, we question whether the Service has the authority to reinstate a compromise absent a finding that one of the bases in the regulation is present.

Based on the foregoing, we stand by our prior advice that a terminated offer in compromise cannot be reinstated. The “reinstatement” essentially forms a new agreement between the taxpayer and the Service. As such, it must be executed in accordance with accepted principles of contract law. Furthermore, because the Service’s authority to compromise is

circumscribed by the Code and Treasury regulations, a new agreement requires a finding that there is an authorized basis for compromise.

HAZARDS & OTHER CONSIDERATIONS

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