

Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Internal Revenue Service
1973 N. Rulon White Blvd
Ogden, UT 84404

Attn: Frivolous Return Program, MS 4390

from: Mark H. Howard
Senior Counsel (Salt Lake City)
(Small Business/Self-Employed)

subject: Erroneous refund of withheld social security tax

We received a request from the Frivolous Return Program (FRP) at the Ogden Campus for advice involving returns filed as part of a scheme in which taxpayers file returns reporting no income but claiming refunds based on income tax withholding and Federal Insurance Contributions Act (FICA) tax withholding. We previously provided you with a response on other questions. This memorandum addresses false claims for refund, which include the Old Age and Survivor Disability (OASDI) portion of withheld FICA tax (i.e., withheld social security tax).

ISSUE

When a return falsely reports and claims a credit for withheld social security tax and the Service makes an erroneous refund based on that request, can the Service recover these amounts using the assessment procedures provided in I.R.C. § 6201(a)(3)?

CONCLUSION

The Service may assess the amount of the withheld social security tax that was erroneously refunded pursuant to the procedures provided in I.R.C. § 6201(a)(3).

FACTS

For our opinion in this matter, we have relied on the facts set out below. If you believe we have misstated the facts or omitted key facts, please let us know as this could affect our opinion in this matter.

Division Counsel SBSE and the IRS FRP based in Ogden, Utah, asked us to provide assistance in the issuance of notices of deficiency asserting fraud against parties who have filed frivolous returns using the pattern promoted by Peter Eric Hendrickson in his book, "Cracking the Code." Persons who follow this pattern report none of their wages as income. They attach to their Form 1040 return a Form 4852, substitute for Form W-2, in which they report wages of \$0 but report the full amount of withholding for income tax, social security, Medicare and state income tax withholding. Most returns following this scheme claim an income tax withholding credit for the combined amount of the income tax withholding, social security withholding and Medicare withholding. Some of the persons filing returns following this scheme claim a credit for excess social security payments on line 64 of the Form 1040 even though the taxpayers have not had withholding of social security taxes on income which exceeds the annual wage base amount for the given year. In either case, if the Service does not recognize the return as a frivolous return, it may process the return and issue the refund. The Service has asked us to determine how to recover an erroneous refund amount based on a false claim for withheld social security tax.

LAW AND ANALYSIS

The Internal Revenue Code (IRC) imposes FICA tax on every employer equal to a percentage of wages paid by the employer with respect to employment. I.R.C. §§ 3111. The Internal Revenue Code imposes a corresponding FICA tax on every employee equal to a percentage of wages with respect to employment. I.R.C. §§ 3101. The FICA tax consists of two components, an OASDI portion and a Medicare portion. Wages for FICA purposes are defined by I.R.C. § 3121(a). The OASDI portion of the FICA tax applies to wages as described in I.R.C. § 3121(a)(1). This provision provides that the OASDI portion of the FICA tax applies to wages equal to the contribution and benefit base (wage base) defined by section 230 of the Social Security Act (42 U.S.C. § 430). Accordingly, under I.R.C. § 3121(a)(1), after wages exceed the annually adjusted wage base (\$102,000 for 2008), they are no longer subject to the OASDI portion of the FICA tax.

Pursuant to I.R.C. § 3102, employers have an obligation to withhold FICA tax from the wages of the employee and pay them over to the Service. If the employer withholds taxes on wages in excess of the wage base for a given year, the employer is supposed to repay the excess to the employee and claim a credit for that amount on the employer's Form 941 return. However, the regulations make clear that the employer may make this correction only if the employee has not claimed or will not claim a refund

or credit for the amount of the excess collected by the employer. See Treas. Reg. §§ 31.6413(a)-2(a) and 31.6402(a)-2(a).

Some individuals work for more than one employer. In that situation, the combined withholding of FICA tax amounts by the two or more employers may exceed the amount due on the annual wage base. In that event, the employee may claim a credit for the excess pursuant to I.R.C. § 31(b) and Treas. Reg. § 1.31-2 on an income tax return, and if there is an overpayment receive a refund; or, if the employee is not required to file an income tax return, and does not file an income tax return, the employee may claim a special refund on Form 843 pursuant to I.R.C. § 6413(c)(1) and Treas. Reg. § 31.6413(c)-1(a)(1)(i), (b)(1). If the taxpayer claims the excess social security tax withholding as a credit under I.R.C. § 31(b), then the statute treats that excess as an amount withheld at source as tax under I.R.C. § 3402 for purposes of subtitle A, i.e., as income tax withholding. We note that I.R.C. § 31(b) references amounts “determined by the taxpayer or the Secretary” as excess social security tax withholding. The Treasury Department has promulgated Treasury Regulations to implement this provision. Those regulations, found at Treas. Reg. § 1.31-2(a)(2) and (3), provide, in relevant part, as follows:

(2) An employee who is entitled to a special refund of employee tax with respect to wages received during a calendar year and who is also required to file an income tax return for such calendar year . . . may obtain the benefits of such special refund only by claiming credit for such special refund in the same manner as if such special refund were an amount deducted and withheld as income tax at the source. . .

(3) The amount of the special refund allowed as a credit shall be considered as an amount deducted and withheld as income tax at the source under Chapter 24 of the Internal Revenue Code. . . If the amount of such special refund when added to amounts deducted and withheld as income tax exceeds the taxes imposed by subtitle A . . . , the amount of the excess constitutes an overpayment of income tax under subtitle A, and interest on such overpayment is allowed to the extent provided under section 6611 upon an overpayment of income tax resulting from a credit for income tax withheld at source. See section 6401(b).

When the Service has made an erroneous refund as a result of a claim by a taxpayer for an overstated income tax withholding credit, the Service recovers that erroneous refund by making an assessment pursuant to I.R.C. § 6201(a)(3). See, e.g., Feldman v. CIR, T.C. Memo. 1967-91, 1967 WL 1115, at page 2 (Tax Court upheld an I.R.C. § 6201(a)(3) math error adjustment for overstated income tax withholding resulting from an unallowable claim of excess Social Security tax withholding). Section 6201(a)(3) provides:

(3) Erroneous income tax prepayment credits. If on any return or claim for refund of income taxes under subtitle A there is an overstatement of the credit for income tax withheld at the source, or of the amount paid as estimated income

tax, the amount so overstated which is allowed against the tax shown on the return or which is allowed as a credit or refund may be assessed by the Secretary in the same manner as in the case of a mathematical or clerical error appearing upon the return, except that the provisions of section 6213(b)(2) (relating to abatement of mathematical or clerical error assessments) shall not apply with regard to any assessment under this paragraph.

Amounts claimed by the taxpayer and refunded under I.R.C. § 31(b) are treated as income tax withheld at source under I.R.C. § 3402 for purposes of subtitle A. Also, amounts within section 31 are specifically excluded from the definition of a deficiency by I.R.C. § 6211(b)(1), and are not specified in I.R.C. § 6211(b)(4). This comports with the definition of what can be assessed under section 6201(a)(3), which is overstated income tax withholding and overstated estimated income tax payments, both of which are excluded from the definition of a deficiency by I.R.C. § 6211(b)(1) and Treas. Reg. § 301.6211-1(b).¹ Therefore, we believe the amount claimed and erroneously refunded under I.R.C. § 31(b) can be recovered in the same manner as an overstated claim for income tax withholding. Accordingly, where amounts are claimed by the taxpayer and refunded under the provisions of I.R.C. § 31(b), the Service can make a summary assessment of the overstated amount claimed using the procedures provided in I.R.C. § 6201(a)(3).

If you have any questions, please contact me at telephone number

DEBRA K. MOE
Area Counsel
(Small Business/Self-Employed:Area 5)

By: /s/ Mark H. Howard
Mark H. Howard
Senior Counsel (Salt Lake City)
(Small Business/Self-Employed)

¹ We point out that the refunded amount, constituting a rebate of the employee's portion of the tax which was collected by the employer and paid over to the IRS, might also be summarily assessed as retaining its character as the employee's portion of Social Security tax. In this regard, if the taxpayer was not required to file an income tax return and had not filed an income tax return, the claimed excess Social Security tax would be claimed as refundable on a Form 843. Nonetheless, where the claim for refund is made on an income tax return, the assessment mechanism that best fits the section 31 characterization is section 6201(a)(3).