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INTERNAL REVENUE SERVICE  
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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. <sup>1/</sup> 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.

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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).

LAW AND ANALYSIS:

(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 (6<sup>th</sup> 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 (6<sup>th</sup> Cir. 1992) (unlimited statute of limitations on assessment

further 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.

If you have any questions, please call 202-622-3630.