



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

OFFICE OF  
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June 30, 2000

MEMORANDUM FOR DISTRICT COUNSEL, PENNSYLVANIA DISTRICT  
CC:NER:PEN:PHI

FROM: Chief, Branch 3 (Income Tax & Accounting)  
CC:DOM:IT&A

SUBJECT: Significant Service Center Advice  
Procedure for Refunds Generated by Processing Errors

This responds to your request for significant advice, dated March 6, 2000, in connection with several questions posed by the Philadelphia Service Center related to the processing of returns after certain initial processing errors have been identified by the Notice Review function.

ISSUES:

What procedures should be followed in the following situations, and how does the answer differ depending on whether the error was detected before the refund was sent?

1. The Service Center initially determines that the tax reported on the return is too high, but then determines in Notice Review that the tax originally reported on the return was correct.
2. The Notice Review function determines that not only was the initial determination of a lower tax incorrect, but the correct tax exceeds the amount reported on the return.
3. Notice Review determines that the initial determination was incorrect, but the correct tax is still lower than the amount reported on the return.

CONCLUSIONS:

1. If the refund has been sent, the Service Center must follow deficiency procedures to recover the refund, because the refund was a "rebate"; if a second assessment was made, corresponding to the amount originally reported on the return, it should be abated. If the amount originally reported was fully paid and the refund has not been sent as a result of the Service Center's initial determination, the Service's records may be adjusted to reflect the taxpayer's correct tax liability.

2. In this situation, there is a deficiency whether or not a refund has been made. If the refund has been made, as a rebate it will increase the amount of the deficiency that must be assessed. Depending on the circumstances, the portion of the deficiency attributable to the excess of the correct tax over the amount reported on the return may be assessable using the "math error" procedures; however, a notice of deficiency must be sent before the portion of the deficiency attributable to the rebate may be assessed. If the amount originally reported was fully paid and the refund has not been made as a result of the Service Center's initial determination, the Service's records may be adjusted to reflect the reversal of the "rebate," but the remaining deficiency must be assessed as such, using math error or deficiency procedures, as appropriate .

3. If the refund has been made, the proper treatment depends on whether the correct tax is greater or less than the tax on the return, reduced by the refund. If it is greater, then deficiency procedures must be followed. If it is less, then the additional refund should be made. If the refund has not been made, the Service may adjust its records to reflect the taxpayer's correct tax liability and send the taxpayer the correct refund.

#### FACTS:

To illustrate these points, we will use the following simplified scenarios:<sup>1</sup>

Scenario 1: The taxpayer, who has \$1000 of prepayment credits (either wage withholding or estimated tax payments), files a return showing \$1000 of tax. The Service Center initially determines that the correct tax is only \$800. The correct tax is actually \$1000.

Scenario 2: The facts are the same, except that the correct tax is \$1300.

Scenario 3: The facts are the same, except that the correct tax is \$900. Alternatively, the correct tax is \$600.

#### DISCUSSION:

##### In General

The term "deficiency" is defined in § 6211 of the Internal Revenue Code as the amount by which:

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<sup>1</sup> For discussion purposes, we have reorganized the factual scenarios as presented in your memorandum into three groups in which the correct tax is (1) the same as, (2) greater than, or (3) less than the tax originally reported by the taxpayer. Within each group, we consider both the refund and the no-refund situation.

the tax imposed [that is, the correct tax] exceeds the excess of—

- (1) the sum of
  - (A) the amount shown as the tax by the taxpayer upon the return, plus
  - (B) the amounts previously assessed (or collected without assessment) as a deficiency, over—
- (2) the amount of rebates made.

This definition has often been summarized using the following formula:

Deficiency = correct tax - (tax on return + prior assessments - rebates); or  
Deficiency = correct tax - tax on return - prior assessments + rebates.<sup>2</sup>

In other words, a “deficiency” is generally an understatement, not necessarily an underpayment, of tax; it is originally based on the discrepancy, if there is one, between the correct tax and the tax on the taxpayer’s return, and is subsequently decreased by assessments and increased by rebates.

Two additional features of the definition of a deficiency are relevant to the present discussion.

First, a “rebate” is defined in § 6211(b)(2) as “so much of an abatement, credit, refund, or other repayment,” as was made on the ground that the tax imposed was less than the excess of the amount specified in § 6211(a)(1) over the rebates previously made—that is, was made on the ground that the correct tax was less than the tax as reported by the taxpayer (adjusted for previous assessments and rebates). In other words, a “rebate refund” potentially increases an understatement of tax, and therefore a deficiency; a “non-rebate refund” does not.

Second, § 6211(b)(1) provides that in determining a deficiency, prepayment credits (wage withholding and estimated tax payments) are ignored in determining both the correct tax and the tax shown on the return. This means, among other things, that a taxpayer may have a deficiency even though, taking into account unrefunded prepayment credits, the taxpayer’s liability is fully paid or overpaid. See, e.g., IRM § (35)(10)35 (Tax Court decision document showing both a deficiency and an overpayment).

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<sup>2</sup> See S-K Liquidating v. Commissioner, 64 T.C. 713, 715 (1975); Miller v. Commissioner, 23 T.C. 565, 568 (1954), aff’d 231 F. 2d 8 (5th Cir. 1956); Kurtzon v. Commissioner, 17 T.C. 1542, 1548 (1952).

Scenario 1Refund Issued

Applying these principles, if the Service Center, in the course of “perfecting” the return in initial processing, issues a refund—because it erroneously determines that the correct tax was less than the tax reported by the taxpayer—then the refund would be a rebate, within the meaning of § 6211(b)(1). If Notice Review then determines that the tax on the return was correct, the result is a deficiency that must be assessed and collected as such. In terms of the simplified fact patterns given above, there is a deficiency of \$200 equal to:

Example 1

Correct tax		\$1000
Less		
Tax on return	\$1000	
Plus prior assessments	0	
Less rebates	<u>200</u>	
		<u>800</u>
		200

Note that there is a deficiency even though the refund was initiated by the Service, not the taxpayer; the definition of a “rebate” in § 6211(b)(1) does not differentiate between Service-initiated and taxpayer-initiated adjustments.<sup>3</sup>

In your memorandum, you ask whether in this situation the Service Center should “follow the erroneous refund procedures and issue a notice of deficiency before the assessment may be changed.” As discussed above, the answer is yes. However, it may be useful to elaborate on this point because of the differing ways in which the term “erroneous refund” is used.

In a broad sense, an “erroneous refund” is any refund that is made when there is in fact no overpayment—that is, when the taxpayer is not legally entitled to the funds. See, e.g., IRM § 21.4.5.2:(1). Used in this sense, it does not matter whether the refund was

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<sup>3</sup> Note also that the deficiency would be the same if the taxpayer had more than \$1000 in prepayment credits, and had therefore received a refund in excess of \$200. For example, if the taxpayer had \$1500 in prepayment credits, and received an initial refund of \$700, the deficiency would still be \$200. Logically, this makes sense, because the Service need only recover \$200 to satisfy the taxpayer’s correct liability. Technically, this result follows from the fact that, as noted earlier, prepayment credits are not taken into account in determining a deficiency under § 6211(b)(1); moreover, the prepayment credits were not “collected without assessment” as a deficiency, within the meaning of § 6211(a)(1)(B). Thus, only \$200 of the \$700 refund would be a “rebate”—the remaining \$500 was not refunded on the ground that the correct tax was less than the tax on the return, but on the ground that the tax on the return was less than the amount paid—and the other amounts in *Example 1* would also remain the same.

a rebate or not, whether it was the result of a substantive error or a procedural mistake, or whether it was caused by a taxpayer's incorrect refund claim or the Service's error.<sup>4</sup> See IRM § 21.4.5.4.4 (classifying erroneous refunds into five categories: "A1", "A2", "B", "C", and "D"); see also IRM §§ 3.17.79.16.5 (discussing recovery methods for the different categories); 121.2.7 (statute of limitations considerations).

Historically, however, the term "erroneous refund" has often been used in a narrower sense, to refer to a non-rebate refund that resulted from a Service error, such as a computer processing mistake, and which therefore requires special handling. (In terms of the classification in the Manual, these refunds would generally fall into "Category D.") This narrower usage still colors the Manual in many places, however, and many Service personnel would consider the phrase "follow the erroneous refund procedures and issue a notice of deficiency" to be a confusing contradiction in terms, since those would be viewed as mutually exclusive alternatives. See IRM § 3.17.79.16.5:(1) and (2).

Using the broader and more accurate terminology, however, your description of the proper procedure is correct. In fact, the Manual uses this situation as an example of what is termed a "Category A1" erroneous refund,<sup>5</sup> and indicates the proper handling in § 21.4.5.4.6.1:(5): "If not a non rebate, complete account action close your open control and permit account to go through the normal notice stream."

### Refund Not Issued

If the initial processing error is caught before a refund or credit is actually made ("Scenario 2" in your memorandum), you describe the current Service Center processing as follows: "the Service Center stops the refund, cancels the initial, erroneous adjustment and changes the assessment to what was reported on the return. No notices are sent to the taxpayer."

We agree with these procedures. Section 6211(b)(2) describes a "rebate" as an "*abatement*, credit, refund, or other repayment" (emphasis added), and it could be argued that if the Service Center first assesses the tax on the return and then mistakenly abates it, that abatement is a rebate that cannot be reversed without following deficiency procedures. For example, this would be the correct procedure if—unlike the scenarios discussed in your memorandum—the taxpayer's prepayment

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<sup>4</sup> In all such cases, the Service has the option of recovering the refund by civil suit under § 7405. However, the Service rarely, if ever, does so unless, for some reason, the simpler alternative of recovering the refund by administrative assessment is not available.

<sup>5</sup> See IRM § 21.4.5.4.4 (3) ("The IRS lowered the tax when originally processing the Form 1040 or 1120 and later determines the taxpayer's amount was correct.")

credits and other payments were not sufficient to satisfy the correct liability.<sup>6</sup> However, in the scenarios described here and in your memorandum, the funds submitted by the taxpayer are sufficient to satisfy the correct liability, the taxpayer did not claim or receive a refund or credit of the abated amount, and the Service is simply adjusting its internal records to reflect the correct tax as reported on the return. In these circumstances, we believe no useful purpose is served by notifying the taxpayer of the mistaken abatement only to retract it immediately by asserting a deficiency.

Legally, this procedure can be justified under the doctrine, first enunciated in Lewis v. Reynolds, 284 U.S. 281 (1932), that the Service has the authority not to allow a refund or credit—even without assessment—when there is no "overpayment," as required by § 6402. See Rev. Rul. 85-67, 1985-1 C.B. 364; Ewing v. Commissioner, 914 F.2d 499 (4<sup>th</sup> Cir. 1990). As a general policy matter, the Service does not use this authority to substitute claim-disallowance procedures for normal deficiency procedures with respect to refunds or credits claimed on original returns, since to do so would effectively deprive taxpayers of their choice between contesting a deficiency in Tax Court, or paying the tax and litigating the matter in a refund forum. However, these policy concerns do not seem to be present when—even though, technically, the abatement may be a "rebate"—the Service has caught its own mistake, and the taxpayer has neither claimed nor received a refund of the amount in question.<sup>7</sup>

It is not clear from your submission whether, in these cases, the Service Center corrects the erroneous abatement by simply reversing the abatement, or by making a new assessment in the amount of the erroneous abatement. The former procedure should be followed if technically feasible—since, as discussed above, technically the abatement was a "rebate" and a new, formal assessment would have to follow deficiency procedures.

You also indicate that in certain cases personnel in Notice Review will process the case under the assumption that the refund has been stopped, only to find that the refund was in fact made. In such cases, because the refund was a rebate, deficiency procedures should be followed to recover the refund.

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<sup>6</sup> Suppose, for example, that the facts were the same as in *Example 1*, except that the taxpayer only had \$800 in prepayment credits and did not pay the remaining \$200 with the return. If the Service mistakenly abated the tax to \$800 on the ground that \$800 was the correct tax, the abatement would be a "rebate," and the Service would have to follow deficiency procedures to reassess and collect the additional \$200, even though the taxpayer originally reported a liability of \$1000.

<sup>7</sup> Because no refund was claimed, a notice of claim disallowance is unnecessary. As you describe, no notices need be sent to the taxpayer.

Scenario 2Refund Issued

If, after an initial processing error in the taxpayer's favor, the Notice Review function determines that the correct tax is greater than the tax reported on the return ("Scenario 3" in your memorandum), then there is a deficiency equal to the excess of the correct tax over the tax on the return, increased by the amount of the rebate refund. For example, using the facts in Scenario 2 above, there would be a deficiency of \$500:

Example 2

Correct tax		\$1300
Less		
Tax on return	\$1000	
Plus prior		
assessments	0	
Less rebates	<u>200</u>	
		<u>800</u>
		500

In connection with this scenario, you ask whether the Service can assess the deficiency using the summary assessment procedures in § 6213(b)(1) that apply to the correction of "mathematical or clerical errors."

The prohibitions in § 6213(a), which generally bar the assessment and collection of deficiency until after a taxpayer has had an opportunity to petition the Tax Court, do not apply if a deficiency results from a mathematical or clerical error appearing on a taxpayer's return. The Service may assess such an error-related deficiency immediately; it must then furnish a notice of the assessment, which sets forth the taxpayer's error and provides an explanation. Under § 6213(b)(2), collection of the deficiency is stayed for 60 days. If the taxpayer requests an abatement during this period, the assessment must be abated, and any reassessment is subject to the deficiency procedures. A mathematical or clerical error is defined in § 6213(g)(2) as one of several specific types of errors.<sup>8</sup>

In the present scenario, the deficiency is composed of two parts: first, there is the portion attributable to the excess of the correct tax over the tax reported on the return (\$300, in the example); second, there is the portion attributable to the erroneous rebate refund (\$200, in the example). If the first portion is attributable to an error of the type listed in § 6213(g)(2), then it is assessable using the math error procedures. However,

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<sup>8</sup> In Service Center usage, an adjustment that results from initial submission processing is generally termed a "math error" regardless of whether it is favorable or unfavorable to the taxpayer. However, the special statutory procedures in § 6213(b)(1) only apply to unfavorable adjustments; from a statutory perspective, a "math error" refund is no different from any other refund.

because the second portion was attributable to the Service's error, not an error appearing on the return, it cannot be assessed under § 6213(b)(1). In such a case, the Service has the option of using math error procedures to assess the first portion, and regular deficiency procedures to assess the second portion, or simply following regular deficiency procedures for both adjustments. (The math error procedures are not mandatory.)

Refund Not Issued

If the initial processing error is detected before the refund is issued, as discussed under Scenario 1 the liability can be corrected on the Service's records to reflect the tax reported on the return. The excess of the correct tax over the tax shown the return (\$300, in the example) must be assessed as a deficiency, or by using math error procedures if appropriate.

Scenario 3

Refund Issued

In this scenario, the correct tax, even after adjustment by Notice Review, is less than the amount shown by the taxpayer on the return. When a refund has been sent to the taxpayer as a result of the initial processing error, the proper handling depends on whether the correct tax is greater or less than the tax as initially reported by the taxpayer, reduced by the rebate. If it is greater, then there is still a deficiency, which must be assessed as such. If it is less, then the additional refund should be sent the taxpayer with an explanation, as indicated in your memorandum.

For example, if we assume the facts are as described in Scenario 1 above, except that the correct tax is \$900, then there is a deficiency of \$100:

Example 3

Correct tax		\$ 900
Less		
Tax on return	\$1000	
Plus prior assessments	0	
Less rebates	<u>200</u>	
		<u>800</u>
		100

However, if the correct tax is actually \$600, then there is no deficiency and the taxpayer is owed an additional \$200 refund.



Refund Not Issued

If, in this fact pattern, the initial refund has not been issued, then the liability can be corrected on the Service's records as in Scenario 1 above, and the taxpayer simply sent the correct refund (\$100, if the correct tax is \$900; \$400, if the correct tax is \$600).

If you have any questions regarding this advice, please contact Sandy Irving or Paul Tellier, at (202) 622-4930.

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By: \_\_\_\_\_  
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