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Significant Service Center Advice Request
Processing of 1993 Deferred Income Tax Payments

This responds to your request for Significant Advice, dated April 16, 1997, in connection to questions posed by the Ogden Service Center.

Disclosure Statement

Unless specifically marked "Acknowledged Significant Advice, May be Disseminated" above, this memorandum is not to be circulated or disseminated except as provided in the CCDM. This document may contain confidential information subject to the attorney-client and deliberative process privilege. Therefore, this document shall not be disclosed beyond the Office or individual(s) who originated the question discussed herein and are working the matter with the requisite "need to know." In no event shall it be disclosed to taxpayers or their representative.

ISSUE

Whether the Service may collect the unpaid portion of the deferred two-thirds of the taxpayer's 1993 income tax liability.

CONCLUSION

The Service may collect the underlying deferred 1993 income tax liability to the extent that this liability was not satisfied by actual payments made by the taxpayer.

FACTS

Under section 13201(d) of the Omnibus Budget Reconciliation Act (hereinafter "OBRA"), high-bracket taxpayers were allowed to pay the increased amount of their 1993 income tax liability in installments over a three year period. Taxpayers paid the first installment as part of the tax paid with their 1993 return. Taxpayers made the election to defer the payment of two-thirds of the 1993 tax increase on their 1993 Form 1040 by attaching a Form 8841 and inserting the amount to be deferred on line 58b of the "Payments" section of the 1993 Form 1040. The first of the two deferred payments was due by April 17, 1995 and the second deferred payment was due by April 15, 1996.

The Service assessed the full amount of the tax due for the 1993 tax year when the 1993 return was processed. The deferred payments were treated as credits. If done properly, the Service coded the credits as a TC 766 entry with a credit reference of TC 334. This coding and credit reference was designed to identify the credit as a 1993 deferral of tax. While the coding made it appear as if the account was fully paid, it was also supposed to trigger the issuance of notices reminding the taxpayers to send in their installment payments for the deferred amounts. In addition, when a payment was credited to a taxpayer's account, a computer program was supposed to automatically reverse the TC 766 code credit, thus, preventing the payment from being refunded to the taxpayer. The computer program, however, did not always work correctly.

Moreover, in a number of instances, the Service incorrectly treated the deferred tax liability as an excess FICA payment. ("Excess social security, Medicare, and RRTA tax withheld" was reported on line 58a of the 1993 Form 1040.) These supposed "Excess FICA payments" were then credited to the taxpayer's 1993 account as payments in satisfaction of the underlying liability. These credits were not coded as a TC 766 entry. Hence, when a taxpayer sent in a payment for the 1993 tax liability, the Service would refund the payment because the account appeared paid. In some instances, the Service would contact the taxpayer to inquire why the taxpayer sent in a payment for the 1993 tax year. This inquiry sometimes resulted in the taxpayer's account being corrected and the payment being properly applied to the deferral.

Taxpayers were also authorized to apply all or part of any overpayment from the two subsequent tax years to their 1993 deferred tax liability. ¹ See Rev. Proc. 94-58, 1994-2 C.B. 745.

For returns received after April 15, 1995, the Service had its computers programmed to automatically setoff the overpayment against the deferred portion of the 1993 tax liability. The programming worked as long as the 1993 account had the TC 766 credit entry on it. However, where the Service incorrectly input the deferral as an excess FICA credit, the overpayment was simply refunded to the taxpayer as if the 1993 liability was paid in full.

For returns filed before April 15, 1995, the Service Center processed the returns but held the money until it posted the payment to the 1993 account on April 15, 1995. Because these payments were processed manually, it enabled the Service to correct many errors which it previously made in designating the deferred amount of tax. However, not all procedural errors were corrected in time for the payment to correctly post to the account, thereby leading to the issuance of a number of erroneous refunds.

DISCUSSION

An assessment can only be extinguished or satisfied by the taxpayer's actual payments and then, only to the extent of those payments. See Bilzerian v. United States, 86 F.3d 1067, 1069 (11th Cir. 1996) (once an assessment is paid, it is extinguished); Clark v. United States, 63 F.3d 83, 89 (1st Cir. 1995) (assessment can only be extinguished by payment tendered by the taxpayer, not IRS error); O'Bryant v. United States, 49 F.3d 340, 347 (7th Cir. 1995) (taxpayer's payment of assessed liability extinguished the assessment). Thus, "[w]hen a taxpayer mails the [Service] a check in the full amount of his assessed tax liability, and the [Service] cashes it, the taxpayer's liability is satisfied." O'Bryant, 49 F.3d at 347. Inadvertent

¹ The instructions for line 62 of the 1994 Form 1040 informed the taxpayer that if he filed a Form 8841 with his 1993 tax return, he could apply part or all of his refund by writing on the dotted line next to line 62 the words "93 OBRA Install." and the amount to be applied. The instructions informed the taxpayer that the refund would first be applied to other outstanding Federal tax liabilities before being applied to the installment due regardless of the taxpayer's instructions.

procedural errors on the part of the Service do not generally extinguish an otherwise valid assessment. Clark, 63 F.3d at 89. When the Service erroneously credits the taxpayer's account, the underlying assessment is not satisfied. See Buffalow v. United States, 109 F.3d 570 (9th Cir. 1997). Instead, the assessment remains on the rolls, unabated and unsatisfied, and may be collected by using normal collection procedures within the ten-year collection period after the Service corrects its mistake. I.R.C. § 6502(a).

The Service may correct its own procedural errors in classifying the deferred two-thirds of the taxpayer's 1993 income tax liability at any time. See Crompton-Richmond Co. v. United States, 311 F. Supp. 1184 (S.D.N.Y. 1970) (The Service can reinstate a liability that has been abated or reduced as a result of a mistake of fact or clerical error not going to the determination of the tax imposed). The Service is not bound by the expiration of the statute of limitations on assessment because the Service is not reassessing the taxpayer's liability. Id. The Service correctly assessed the full amount of the tax due for the 1993 tax year when the taxpayer filed his or her return for that year. To the extent that the Service erroneously treated the deferred amount as excess FICA payments, the Service may correct those errors at any time.

The reversal of incorrect credits, however, does not automatically revive the underlying assessment. Only to the extent that the underlying assessment for the 1993 tax year was not paid by the taxpayer, can the Service take administrative collection action on that assessment. See, e.g. Bilzerian, 86 F.3d at 1069 (once an assessment is paid, it is extinguished).²

Problems Associated with Taxpayer's Payments

In order to ascertain whether the underlying assessment has been paid, the Service should first examine the taxpayer's 1993 account. If the taxpayer's account for the 1993 tax year reflects any payments, the underlying assessment is extinguished in the amount of these payments regardless whether the Service kept or refunded these payments. For example, lets assume that the taxpayer's original income tax liability subject to payment by

² We suggest that the Service afford the affected taxpayers an opportunity to satisfy their 1993 liability before the Service takes any additional steps to collect the unpaid portion of the 1993 deferred liability.

installments was \$1200 and the taxpayer made two payments in the amount of \$400 each - one with the 1993 tax return and one by April 17, 1995. The second payment, however, was refunded as a result of the Service's error in coding the credit. After correcting the error in coding the credit, the Service can administratively collect only an additional \$400 of the original assessment. This \$400 represents the amount of the original assessment (\$1200) minus the two payments totalling \$800. The \$400 refund may be recovered by following proper erroneous refund procedures such as by securing a voluntary repayment of these refunds, by offsetting the resulting underpayment against a refund due the taxpayer with respect to any year or any type of tax, or by filing an erroneous refunds suit pursuant to I.R.C. § 7405.³ All three of these options are subject to the time limitations set forth in I.R.C. § 6532(b).

Problems Associated with Overpayment Option

The legislative history of OBRA indicates that the Service was given broad discretion to supervise the deferral of the 1993 income tax liability. Pursuant to Rev. Proc. 94-58, the deferring taxpayers could satisfy all or part of the deferred 1993 income tax liability by designating any portion of an overpayment for the taxable year 1994 and/or 1995 to the second and/or third installment. The Revenue Procedure, however, warned the deferring taxpayers that the Service was not bound by a taxpayer's designation. Specifically, the Revenue Procedure provided:

Taxpayers choosing the overpayment option of paying an installment are cautioned ... that the Internal Revenue Service will apply such a designated overpayment first to any other outstanding federal tax liability,

³ Whether the Service can use deficiency or summary assessment procedures to assess the amount of a nonrebate erroneous refund is not clear. Compare Bilzerian, 86 F.3d 1067; O'Bryant, 49 F.3d 340, with Clayton v. Commissioner, T.C. Memo 1997-327 (July 21, 1997); Lesinski v. Commissioner, T.C. Memo 1997-234 (May 21, 1997). See also Clark, 63 F.3d at 87. While both the Service and the courts agree that section 7405 is not the Service's exclusive remedy for the recovery of nonrebate erroneous refunds, no court has squarely addressed the issue of whether the Service has the authority to assess nonrebate erroneous refunds.

notwithstanding any taxpayer designation.

Some taxpayers took advantage of this payment option. The Service, however, did not always follow a taxpayer's designation. In some instances, the Service either applied the overpayment to the taxpayer's other outstanding Federal tax liability or refunded the full amount of the overpayment.

A. Overpayments applied to the taxpayer's 1993 liability as designated; Erroneous refund issued

Where the Service actually applied the 1994 and/or 1995 tax year overpayment to the 1993 tax year as designated, the taxpayer's liability was extinguished in the amount of the payment(s). See United States v. Wilkes, 946 F.2d 1143, 1150-51 (5th Cir. 1991). The Service may administratively collect only that portion of the taxpayer's deferred 1993 liability which has not been satisfied. Id. If the Service erroneously refunded any portion of the overpayment actually applied to the taxpayer's 1993 account, the Service may proceed to recover the amount refunded by following proper erroneous refund procedures.

B. Overpayments applied to the taxpayer's other outstanding tax liabilities

Section 6402(a) authorizes the Service to offset the amount of an overpayment against any liability in respect of an internal revenue tax. Further, Rev. Proc. 94-58 specifically authorized the Service to apply the taxpayer's 1994 and 1995 overpayments to any other outstanding tax liabilities of the taxpayer even though the taxpayer designated the overpayments to be applied to the 1993 deferred liability. Thus, application of these overpayments to other outstanding tax liabilities of the taxpayer would not be erroneous. The Service may still collect the full unpaid portion of the taxpayer's deferred 1993 income tax liability.

C. Overpayments not applied as designated; Refund issued for the 1994 or 1995 tax year

The Service's failure to follow the taxpayer's instructions to apply part or all of the overpayment for the 1994 and/or 1995 tax year to the taxpayer's 1993 liability should not constitute an erroneous refund. The Service should argue that the failure to follow a taxpayer's designation is just that, a failure to follow a taxpayer's designation, and that such failure does not rise to the level of an erroneous refund. Section 6402(a) authorizes the Service to offset any amount of an

overpayment against any liability with respect to an internal revenue tax. This provision is not mandatory. On the other hand, the Service is required to refund any part of an overpayment not used to offset another liability. Accordingly, the Service should argue that where, as here, the 1993 liability appeared fully paid, the Service was required by section 6402 to refund to the taxpayer the entire amount of the overpayment. As such, the refund was not erroneous. The Service should treat these refunds as it would treat any refund of an overpayment where the taxpayer designated the overpayment to another tax liability. See Accounts Resolutions Handbook, Sections 767 and 768. At best, the taxpayer may be entitled to abatement of a portion of the penalties and/or interest for the 1993 tax year. See IRM (20)341.8; also I.R.C. § 6404(e); Treas. Reg. § 301.6404.2T.

If you have any questions or comments regarding this matter, please contact Inga C. Plucinski at (202) 622-3620 or Daniel J. Parent at (202) 622-4930.

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