

ACKNOWLEDGED SIGNIFICANT ADVICE, MAY BE DISSEMINATED

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**Internal Revenue Service
memorandum**

CC:EL:GL:Br2:Campbell
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date: DEC 17 1997

to: Rocky Mountain Associate District Counsel CC:WR:RMD:SLC

from: Senior Technician Reviewer, Branch 2 (General Litigation)
CC:EL:GL:Br2

subject: Significant Service Center Advice - Erroneous Direct Deposits

This responds to your request for Significant Advice dated September 12, 1997, and received in this office on September 19, 1997, in connection with a question posed by the Ogden Service Center.

Disclosure Statement

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Issue

When a refund direct deposit is made to the wrong bank account through no error on the part of the taxpayer, what means are available to the Service to recover the incorrectly deposited sums and to insure that the taxpayer receives the refund to which he/she is entitled?

Conclusion

(1) Where the bank improperly deposits sums into the account of a third party through no fault of the Service, the Service is not obligated to pay the bank. The bank must recover from the owners of the account to which the sums were erroneously deposited. See generally U.C.C. § 4A-303(c).

(2) Where the Service erred in providing the correct information to the bank, a refund check must still be issued to the proper taxpayer. The Service must pursue collection from the third party that benefitted from the Service's error.

Facts

The Ogden Service Center has discovered that in some instances where taxpayers have requested the direct deposit of refund amounts into their bank accounts, the refund amount was not deposited into the taxpayer's account, but was erroneously deposited into the account of some third party. The Service Center has attempted to correct deposit errors by contacting the bank and requesting sufficient information to have the erroneously deposited sums moved to the correct account. Banks have refused to provide the Service Center with the name and account number of the third party who actually received the funds. We assume that this problem occurs because payment information is transferred electronically. The Service or the Treasury issues an electronic order to a bank designated by the taxpayer to pay a taxpayer identified only by numbered account.

Where the taxpayer is the cause of the erroneous deposit, the taxpayer is advised that he/she must contact the bank to work out the problem. However, where the error is made by the bank or the Service, there are apparently no procedures in place to insure the taxpayer receives his/her refund or that the Service recoups the improperly deposited funds.

To get the erroneously deposited funds into the hands of the correct taxpayer, District Counsel has suggested that the Service either get the bank to move the funds to the account of the correct taxpayer or that the Service recover the funds by initiating an erroneous refund suit against the party in receipt of the funds. The Service would like to develop procedures to resolve these problems without violating the disclosure provisions of I.R.C. § 6103. The issues and the applicable law are aptly outlined in the September 12, 1997, memorandum of District Counsel.

Discussion

(1) Where the Service properly directs a taxpayer's refund to the bank and the account designated by the taxpayer and the taxpayer does not receive the refund because of an error committed by the bank, the Service has no obligation to pay the bank, i.e., the bank is not entitled to payment from the Service/Treasury and the Service is freed from the obligations undertaken in issuing the payment order to the bank. The Service's payment transaction to the bank can be

reversed and the bank will have to recover the amount it erroneously issued from the third party benefiting from the error. See U.C.C. § 4A-303(c); generally General Electric Capital Corp. v. Central Bank, 49 F.3d 280, 282 (7th Cir. 1995).

If the payment order to the bank is reversed, the Service/Treasury has not actually issued a refund to the appropriate taxpayer and the Treasury has expended no public funds, allowing for the issuance of a refund to the appropriate taxpayer. However, reversal of the Service's payment order may not actually be necessary once the taxpayer's financial institution is apprised of the error, since a bank receiving the right payment information is obligated to credit the amount of payment to the designated account of the appropriate recipient. See generally 31 C.F.R. § 210.7(d) and (e). Once the credit is made to the account of the taxpayer, the Government has no further obligation for the amount of the payment. See generally, 31 U.S.C. § 3332(h) and 31 C.F.R. § 210.10. 1/

(2) Where an error is made by the Service in transmitting the appropriate information to the bank with respect to the taxpayer's direct deposit refund request, the matter is a little more complicated and the law far from clear. If the bank is promptly notified of the error, (usually within 5 days of the transaction pursuant to the automated clearinghouse rules), the bank may transfer the payment amount to the appropriate account or credit the Service's account for the payment amount. See generally U.C.C. § 4A-207; General Electric Capital Corp. v. Central Bank, 49 F.3d at 282 (7th Cir. 1995). Such a transfer would not require that the Service be provided any information regarding the bank's customer. However, where the bank is unable to recover the deposited amounts or notification of the error is not timely, (and it will probably be the extremely rare case where the Service discovers its error within 5 days

1/ Section 3332 of Title 31 of the United States Code only applies to payments that are required to be made by direct deposit. Tax refunds are not required to be made by direct deposit. Accordingly, tax payments are specifically excluded by section 3332(j)(3). However, where tax refunds are made pursuant to direct deposit requests by the taxpayer, we see no reason why the provisions of this section would not be applicable. See 31 C.F.R. § 210.2.

of the issuance of the payment instruction for the refund), the bank has no further obligation to assist in the recovery of the wrongfully deposited funds. 2/

The risk of loss with respect to the error made by the Service with regard to a direct deposit payment instruction for the taxpayer's refund is on the Service. Thus, the responsibility rests with the Service to ensure that the taxpayer receives the refund he/she is entitled to and that every effort is made to recover the amounts that were erroneously issued. Although it is clear that the Service has an inherent right to recover the misdirected funds, see City of New Orleans v. United States, 371 F.2d 21 (5th Cir. 1967), whether our recovery is based on a general right of restitution or a statutory one, the issue is complicated by the fact the recipient of the misdirected amounts in these cases is unknown to the Service. 3/

The normally recognized mechanism for the Service's recovery of an erroneous disbursement not involving the recomputation of a tax liability (nonrebate) is the filing of an erroneous refund suit pursuant to the authority provided by I.R.C. § 7405, within the time limitations specified by section 6532(b). 4/ Section 6532(b) requires that the Service initiate suit within two years of making an erroneous payment. As it is unlikely that fraud can be established on the part of the recipient of the refund in these cases, the five year limitation period for fraud has no applicability.

2/ Information regarding the automated clearinghouse rules was obtained from the Office of Chief Counsel, Financial Management Service. The automated clearinghouse rules are private industry rules achieved through multilateral contracts among the participants. Copies of the rules are available through the National Automated Clearinghouse Association.

3/ The Supreme Court recognized very early on that the government can recover money paid out of the public treasury by mistake. Fenemore v. United States, 3 U.S. 357, 363 (1797).

4/ Although it may be arguable whether the recovery of funds in the hands of a party who has done nothing to cause the deposit of the funds in his/her account can be regarded as an erroneous refund, it has consistently been the position of this office that the term erroneous refund is broadly defined. Thus, an erroneous refund includes any receipt of money from the Service to which the recipient is not entitled regardless of whether the recipient is the person the Service intended to pay. See generally United States v. Mcree, 7 F.3d 976 (11th Cir. 1993).

However, as indicated above and in your memorandum, recovery of these sums will prove to be difficult in light of the fact that the identity of the third party actually receiving the payment will be known only to the bank, not the Service. As has been the experience of the Odgen Service Center, because banks have an obligation to protect the privacy of their customers pursuant to the Right to Financial Privacy Act, 12 U.S.C. § 3401 et seq., it is unlikely that attempts to secure identifying information with respect to the bank's customers will be voluntarily forthcoming.

It continues to be the position of this office that where the Internal Revenue Code provides procedures for disclosing financial records, such procedures are excepted from the Right to Financial Privacy Act. But see Neece v. Internal Revenue Service, 922 F.2d 573 (10th Cir. 1990). However, Neece is not the hurdle that has to be overcome in these cases. It is not clear that the Service's procedures for securing information, with or without a summons, are sufficient to reach unnamed taxpayers whose tax return is not being examined, or whose tax liability is not being determined or collected, or where there is no basis for believing that the unnamed taxpayer failed or may have failed to comply with the tax laws. 5/ See I.R.C. § 7602(a); 7609(f)(2); United States v. Gertner, 65 F.3d 963, 972 (1st Cir. 1995). 6/ If the Internal Revenue Code does not provide a procedure for securing this information, the Right to Financial Privacy Act will prohibit disclosure of any information regarding the bank's customer to the Service.

Without the identity of the recipient of the erroneous refund, the Service cannot utilize its authority pursuant to section 7405. Accordingly, the Service may have to file suit pursuant to I.R.C. § 7402(a) which gives the district courts the power to fashion any order necessary for the administration or enforcement of the internal revenue laws. Lastly, the Service may have to rely on federal common law to effect a recovery in these cases, since the Service has a

5/ Since there are a number of cases supporting the conclusion that a nonrebate erroneous refund is not a tax liability, the issue of whether the Service can utilize its summons authority is likely to become an additional issue in litigation. See O'Bryant v. United States, 49 F.3d 340 (7th Cir. 1995); Schipper v. United States, 97-1 U.S.T.C. ¶ 50,126 (E.D.N.Y. 1996).

6/ The term "taxpayer" is used here for expedience, as it is entirely possible that the recipient of the misdirected funds is a party to whom the internal revenue laws are not currently applicable.

recognized right to recover money mistakenly paid out of the public treasury. See City of New Orleans v. United States, supra. However, if suit is filed based on either section 7402(a) or federal common law, we recommend that such suits be initiated within the two year limitations period for erroneous refunds provided by section 6532(b). 7/

Conclusion

There is no case law addressing the issue of the recovery of tax refunds erroneously deposited through electronic means. Where the error is made by the bank and not the Service, recovery of the refund amounts (or proper application to the right account), should cause little difficulty for the Service or the taxpayer. But in the case where the error was made by the Service, the risk of loss rests with the Service and not the bank. Although the Service has a legal right to recover amounts paid in error, where the Service has direct deposited a taxpayer's refund in the account of some unknown third party, there is no clear legal path to effect that recovery.

The statutory authority provided under section 7405 to file suit to recover erroneous refunds is of little value, if the Service cannot identify the recipient of the misdirected payments. As noted herein, it is very unlikely that banks will voluntarily supply the Service with information regarding customers receiving misapplied funds for fear of violating the Right to Financial Privacy Act. The exception provided for the Service in the Right to Financial Privacy Act may be of little use, as the Internal Revenue Code has no procedures which would require the disclosure of information unrelated to the determination or collection of a tax liability and there is no basis for believing that the unnamed taxpayer may have failed to comply with the tax laws.

Although the Service may rely on the district courts to fashion a remedy pursuant to section 7402(a) or based on a federal common law theory of restitution, these remedies are untested. Thus, we recommend the following:

7/ As your memorandum does not address any specific taxpayer or tax return information that the Service would need to disclose to the bank in correcting an erroneous transaction that the bank is not already privy to or that the taxpayer has not authorized by virtue of the direct deposit request, this issue is not addressed in this memorandum. If you have a more specific question, please advise and a response will be provided.

(1) The Service develop some type of cross check system that will limit the number of errors made when inputing information relative to direct deposit accounts.

(2) When the Service receives notification that the transfer has been completed, the notification be cross checked against the account as soon as reasonably possible, so that any error can be detected readily. If the bank is notified in a timely fashion, sometimes it may be possible to have an erroneous transaction reversed.

(3) Where it is too late to reverse a transaction and the bank will not voluntarily provide information which would identify the refund recipient, the Service should develop a form letter to supply to the bank that can be forwarded to the bank's customer instructing the customer to contact the Service. The letter should include some identifying number, so that when the customer contacts the Service, the Service will be able to associate the contact with the appropriate refund case.

(4) In cases where the Service receives no response from the customer and in cases currently pending where there is six months or less remaining on the two year limitations period, these cases should be evaluated for litigation potential and referred to district counsel.

If you have questions or need additional information, please contact me or Carol A. Campbell of my staff at (202) 622-3620.

/s/
JOSEPH W. CLARK

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