

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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to: Kimberly A. Daigle
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(Small Business/Self-Employed)

from: Ashton P. Trice
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(Procedure & Administration)

subject: Assertion of additional penalties with respect to Forms 1040 and 1040X that claim refunds based on overstated withholding

This Chief Counsel Advice responds to your request for assistance concerning the liability for penalties of . This advice may not be used or cited as precedent.

ISSUES

1. Are the original returns at issue, which falsely claim Form 1099-OID income and tax withholding, valid returns?
2. If the original returns are valid, is there an underpayment such that the section 6663 fraud penalty could apply?
3. Did the amended returns filed for tax years and result in underpayments such that the section 6663 fraud penalty could apply, even though the Service did not pay her the refunds that she claimed?

CONCLUSIONS

1. It is likely that a court will consider the returns in question to be valid, even if they contain a frivolous position. As an alternative position, any notice of deficiency

should treat the returns as invalid and determine a fraudulent failure to file penalty under section 6651(f).

2. To the extent it is valid, [redacted] return will give rise to an underpayment potentially subject to the fraud penalty under section 6663. [redacted] and [redacted] returns and [redacted] return, which claimed refunds that the Service did not pay, will not give rise to underpayments and the section 6663 fraud payment is inapplicable. We recommend assertion of the section 6676 penalty on erroneous claims for refund or credit.
3. The amended returns [redacted] filed for tax years [redacted] and [redacted] did not result in an underpayment. The section 6663 fraud penalty is inapplicable, but the Service could assess the section 6676 penalty on erroneous claims for refund or credit.

FACTS

[redacted] participated in an Original Issue Discount (OID) scheme with respect to the [redacted] and [redacted] taxable years. Both taxpayers utilized [redacted], promoter of Form 1099-OID schemes, to prepare their [redacted] and income tax returns. The position the [redacted] took with respect to tax years [redacted] has been identified as frivolous for the purposes of the section 6702 frivolous filing penalty. See Notice 2010-33, 2010-17 I.R.B. 609. The [redacted] filed separate returns for tax years [redacted].

On or about [redacted], [redacted] filed a purported income tax return for tax year [redacted]. On it, he claimed Form 1099-OID income of [redacted] and an identical amount of tax withheld. No Form 1099-OID was attached. The purported return was processed by the Service and a refund of [redacted] was issued to the taxpayer. On or about [redacted], a \$5,000 section 6702 frivolous filing penalty was assessed with respect to [redacted] purported [redacted] return. Subsequent to the filing of the purported [redacted] tax return, [redacted] filed purported returns for the tax years [redacted].

On or about [redacted], [redacted] filed a purported income tax return for tax year [redacted]. On it, he claimed Form 1099-OID income of [redacted] and an identical amount of income tax withheld. He attached to his [redacted] return Forms 1099-OID designating income and nearly matching withholding amounts from [redacted].

[redacted]. All of these entities verified that there are no Forms 1099-OID associated with these accounts. The purported [redacted] return was not processed and no refund was issued. On [redacted], a \$5,000 frivolous

filing penalty under section 6702 was assessed with respect to the purported return.

On or about _____, _____ filed a purported tax return for tax year _____. On it, he claimed Form 1099-OID income of _____ and an identical amount of income tax withheld. He attached to his return Forms 1099-OID designating income and nearly matching withholding amounts from _____.

Both of these entities have verified that there are no Forms 1099 associated with these accounts. The purported _____ return was processed but the requested refund was frozen. On _____, a \$5,000 section 6702 frivolous filing penalty was assessed with respect to the purported _____ return.

_____ was not employed during the tax years at issue. He refused to cooperate with the Internal Revenue Service Criminal Investigation unit and the revenue agent in this case. The taxpayer ignored attempts to contact him via telephone and letter and refused to answer his door when special agents attempted to contact him at his residence. _____ responded to an IRS Letter 3176C, informing him that his filings were frivolous, by submitting a document entitled "Memorandum of Law in Support of 1099OID – Original Issue Discount."

On _____, _____ was indicted on charges under 18 U.S.C. § 287, Filing False Claims with a Governmental Agency/ Filing A False Income Tax Return and Title 18 U.S.C. § 2, Aiding and Abetting with respect to the _____ taxable years. On _____, a Second Superseding Indictment was filed which added to the earlier charges a charge for violation of Title 26 U.S.C. section 7201, Willful Attempt to Evade or Defeat the Payment of Tax, for the _____ taxable years. On _____, a jury found _____ guilty of all charges.

Like her husband, _____ filed a Form 1040 for _____ claiming OID income of _____ and _____ of income tax withholding. The tax return was processed by the Service and a total refund of _____ was paid. On or about _____, a frivolous return penalty was assessed with respect to _____ purported return. Subsequent to the filing of the _____ tax return, the taxpayer filed amended tax returns for the _____ and _____ tax years.

On or about _____, _____ filed an amended _____ income tax return claiming additional Form 1099-OID income of _____ and an identical amount of additional withholding on the return. On a Schedule B, _____ listed interest income from _____.

amended return was processed, but the requested refund of _____ was frozen.

On or about _____, _____ filed an amended _____ income tax return claiming additional Form 1099-OID income of _____ and an identical amount of additional withholding on the return. She attached to her _____ amended return Forms 1099-OID designating income and nearly matching withholding amounts from _____

_____. This amended return was not processed and the refund claimed on the amended return was not issued.

The entities named on the taxpayer's Schedules B for the amended _____ and _____ returns and the purported original return for _____ confirmed that the amounts stated on the Schedule Bs were the account balances or amounts available for credit. These amounts were not income to _____ and were not withheld from her as she reported on her amended returns for _____ and _____ and her original _____ return. The only interest income _____ correctly stated on her amended tax returns for _____ and _____ was _____ and _____, respectively, from _____.

_____ was employed by _____, from _____, _____ Her personnel file indicates that she has received training in several courses regarding loans as well as individual tax return and business tax return training.

After examination of _____ through _____ tax years, adjustments were made to correct her filing status. In addition, for _____, adjustments were proposed to reverse the interest income and federal tax withholding associated with the false Forms 1099-OID.

_____ refused to cooperate with the Internal Revenue Service Criminal Investigation unit and the revenue agent in this case. She ignored attempts to contact her via telephone and letter. She refused to answer any questions by the Internal Revenue Service Criminal Investigation unit when two special agents appeared at her place of employment. She responded to a Letter 3176C, informing the taxpayer her filings were frivolous, by submitting a document entitled "Memorandum of Law in Support of 1099OID – Original Issue Discount."

On _____, _____ was indicted on charges under 18 U.S.C. § 287, Filing False Claims with a Governmental Agency/ Filing A False Income Tax Return and Title 18 U.S.C. § 2, Aiding and Abetting with respect to the _____ and _____ taxable years. She pled guilty to a violation of 18 U.S.C. § 287 for Filing A False Income Tax Return and 18 U.S.C. § 2 for Aiding and Abetting related to _____. As part of that plea agreement the government agreed to dismiss the remaining criminal charges for _____

LAW AND ANALYSIS

1. The returns filed for tax years , and and filed for are likely valid.

The section 6663 fraud penalty cannot apply when a taxpayer has not filed a valid tax return. See sec. 6664(b); Mohamed v. Commissioner, T.C. Memo. 2013-255. Therefore, to determine whether and are subject to the fraud penalty under section 6663, we must first determine whether the purported returns they filed for tax years , and constitute valid tax returns.

Courts have treated as valid returns that claim refunds on the basis of overstated withholding. See, e.g. Feller v. Commissioner, 135 T.C. 497 (2010); Young v. Commissioner, T.C. Memo. 2015-18. To be valid, a return must meet the following four requirements: (1) it must contain sufficient data to calculate tax liability; (2) it must purport to be a return; (3) it must be an honest and reasonable attempt to satisfy the requirements of the tax law; and (4) it must be executed by the taxpayer under penalties of perjury. See Beard v. Commissioner, 82 T.C. 766, 777 (1984). A return that is incorrect, or even fraudulent, may still be a valid return if “on its face [it] plausibly purports to be in compliance.” Badaracco v. Commissioner, 464 U.S. 386, 396-397 (1984).

The Forms 1040 filed by for , and and by for meet the first three requirements of the Beard test. As to the first requirement, the returns filed by the for the years at issue contain sufficient data to calculate the ’ tax liability because, aside from the overstated withholding, the returns were largely correct. As to the second and fourth factors, all the returns purported to be returns and were executed under penalties of perjury.

Whether the purported returns were an honest and reasonable attempt to satisfy the requirements of the tax law, in satisfaction of the third requirement, is a closer call. For the frivolous filing penalty to apply, section 6702 requires that the purported return contain information that “on its face indicates that the self-assessment is substantially incorrect.” Sec. 6702(a)(1)(B). Because the Service assessed the section 6702 penalty, it determined that the Forms 1040 the submitted contained some information that, on the face of the returns, indicated that the self-assessments were incorrect. It’s arguable that if a return is so facially implausible that a section 6702 penalty applies, that return may also fail the third prong of the Beard test: that it be an honest and reasonable attempt to satisfy the requirements of the tax code.

However, rarely, if ever, has a court found a purported return to be invalid solely for failure to satisfy the third prong of the Beard test. See Sakkis v. Commissioner, T.C.

Memo. 2010-256, *7. As we noted previously, the _____ accurately reported most of their tax information for the years at issue. The inclusion of falsely overstated withholding information renders their returns inaccurate, but likely not invalid. See e.g., Feller v. Commissioner, 135 T.C. 497 (treating as valid returns which falsely reported overstated withholding attributable to false OID income); Sadler v. Commissioner, 113 T.C. 99 (1999) (treating as valid returns which falsely overstated taxpayer's income tax withholding); Rice v. Commissioner, T.C. Memo. 1999-65 (same). Most likely, a court would find that the returns are valid returns sufficient to give rise to liability for the fraud penalty under section 6663, if there is an underpayment. To guard against the possibility that the returns are not valid, the Service should include the section 6651(f) fraudulent failure to file penalty as an alternative position in any statutory notice of deficiency issued to the _____ for the years at issue.

2. Determination of an Underpayment on Original Returns

Section 6663 imposes a penalty of 75 percent on any underpayment attributable to fraud. Sec. 6663(a). The Tax Court has repeatedly found that the overstatement of withholding credits can give rise to an underpayment subject to the fraud penalty under section 6663. See Feller, 135 T.C. 497; Sadler, 113 T.C. 99 (1999); Rice, T.C. Memo. 1999-65. Section 6664(a) defines an underpayment of income tax as the amount by which the tax imposed exceeds the excess of (A) the sum of (i) the amount shown as the tax by the taxpayer on his return, plus (ii) amounts not so shown that were previously assessed (or collected without assessment), over (B) the amount of rebates made. This definition can also be expressed using the following formula:

$$\text{Underpayment} = W - (X + Y - Z)$$

W = the amount of income tax imposed

X = the amount shown as the tax by the taxpayer on his return

Y = amounts not so shown previously assessed (or collected without assessment); and

Z = the amount of rebates made

See Treas. Reg. § 1.6664-2(c); see also Feller, 135 T.C. 497 (2010) (upholding the validity of the regulation, as applied to an underpayment resulting from overstated withholding credits).

The amount shown as tax by the taxpayer on his return (X) is further defined as the tax liability reported by the taxpayer on his return, reduced by any amounts shown by the taxpayer as credits for tax withheld over any amounts actually withheld. See Treas. Reg. § 1.6664-2(c). If a taxpayer reports withholding credits in excess of both the reported tax liability and the amounts actually withheld, the X variable will be a negative number.

The amount collected without assessment (Y) is the amount by which the total of the estimated tax and other payments made before the return is filed exceed the tax shown

on the return. See Treas. Reg. § 1.6664-2(d). In “frozen refund” situations, i.e. where a taxpayer has claimed a refund, but where the amount has not been refunded or credited to the taxpayer, the Service has adopted the practice of treating the amount of the frozen refund as a sum collected without assessment. In many cases, the net result will be that the X variable and the Y variable will cancel each other out such that no underpayment will exist.

The amount of rebates made (Z) is the amount of any abatement, credit, refund, or other repayment made on the ground that the tax imposed was less than the excess of the sum of the amount shown as the tax by the taxpayer on his return plus amounts not so shown, but previously assessed or collected without assessment over rebates previously made. See Treas. Reg. § 1.6664-2(e). If the Service erroneously makes a refund of tax on the basis that a taxpayer claimed withholding of income tax in excess of the amount of tax actually withheld, such refund is not a “rebate” made on the ground that the tax imposed is less than the amount shown as tax by the taxpayer on the return. Instead, it is an erroneous refund paid as a result of the amount shown as tax by the taxpayer on his return and will not be taken into account in calculating the amount of an underpayment under section 6664.

Applying the underpayment formula to _____ Form 1040, the underpayment would be calculated as follows. As far as we are aware, _____ had no income tax liability for tax year _____, so the (W) variable, the amount of income tax imposed, is _____.¹ _____ reported a tax liability of _____ on his _____ Form 1040 and, despite reporting income tax withholding of _____, no income tax was actually withheld from _____ for tax year _____. Therefore, the (X) variable for his _____ year will be the amount shown as tax on the return, _____, minus the _____ he reported as income tax withheld, which equals _____. The (Y) variable for his _____ year is _____ because _____ claimed a refund in the amount of _____, but the refund was frozen and no amount was refunded or credited. Finally, the (Z) variable is also _____ because no rebates were made. Plugging these variables into the formula results in no underpayment, as the X and Y variables cancel each other out:

(W) amount of income tax imposed

(X) amount shown as tax on the return

(Y) amounts not so shown previously assessed
(or collected without assessment)

(Z) amount of rebates made

¹For the purposes of these calculations, we assume that _____ correctly reported no income tax liability for tax year _____. However, if our assumption is incorrect and his liability for income tax for that year was other than _____, the underpayment calculation will need to be adjusted accordingly.

Underpayment amount

This same analysis also yields an underpayment of _____ for _____ return:

Return

(W) amount of income tax imposed _____²

(X) amount shown as tax on the return

(Y) amounts not so shown previously assessed
(or collected without assessment)

(Z) amount of rebates made

Underpayment amount

We are unable to accurately determine the amount of any underpayments for the _____ returns because both _____ and _____ reported taxable retirement income for those years. It will be necessary first to determine the correct amount of income tax imposed for those years before the underpayment amounts can be correctly calculated. However, the underpayment amounts for those years can be determined using the same methodology outlined above. We note that for the _____ tax year, _____ claimed a refund in the amount of _____ and that a refund in that amount was issued. Although the exact amount of the underpayment will depend on the correct amount of income tax imposed for tax year _____, _____ will likely have an underpayment for tax year _____. For the _____ year, _____ claimed a refund in the amount of _____. Her claim for refund was frozen and no refund was issued to her for the _____ year. Using the methodology above, it is likely that _____ will have no underpayment for tax year _____.

Section 6663 imposes a penalty of 75 percent of any underpayment attributable to fraud. _____ return likely gives rise to an underpayment, to which the 6663 fraud penalty is applicable. For the other years at issue – _____ and _____ for _____ and _____ for _____ – where no underpayment exists, the 6663 fraud penalty is inapplicable. For those years, the Service could assess the section 6676 penalty on erroneous claims for refund or credit.

3. Determination of an Underpayment on Amended Returns

² As with _____, we assume that _____ had no income and no income tax liability for tax year _____. If his tax liability for tax year _____ was other than _____, the underpayment calculation will need to be adjusted accordingly.

Amended returns differ from original returns in that a taxpayer is required to file an original return, whereas amended returns are a matter of administrative grace. See Badaracco, 464 U.S. at 393. And, as the Tax Court noted, “rejection of a claim for refund or abatement in an amended return does not convert the disallowed claim into a deficiency.” Fayeghi v. Commissioner, T.C. Memo. 1998-297, *4. Further, as explained above, the Service has adopted the practice of treating the amount of a frozen refund as a sum collected without assessment. Thus, underpayments cannot arise from false refund claims that are not paid.

The appropriate penalty for this type of situation – where a taxpayer makes a false claim for refund that is not paid – is the section 6676 penalty on erroneous claims for refund. Section 6676 provides that, where a taxpayer makes a claim for refund that is erroneous and without a reasonable basis,³ a penalty equal to 20 percent of the amount erroneously claimed will apply. See sec. 6676(a). and amended returns made claims for refund that were both erroneous and, as discussed in the facts, without reasonable legal or factual basis. Consequently, those claims are subject to the 20 percent penalty imposed by section 6676. If exam wants to assert a penalty with respect to and amended returns, the section 6676 penalty is the correct penalty to assert.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[REDACTED]

[REDACTED]

³ Section 209 of the recent PATH Act, Pub. L. 114-113 Div. Q (2015), amended section 6676 by replacing the phrase “reasonable basis” with the phrase “reasonable cause”. The PATH act does not specify an effective date for that for that amendment. However, in the absence of any clear direction from Congress with respect to effective date, a law is presumed to take effect on the date of its enactment, here December 18, 2015. See Gozlon-Peretz v. United States, 498 U.S. 395, 404 (1991). Because amended returns were filed before December 18, 2015, the reasonable basis exception, not the reasonable cause exception, applies to her claims for refund.

⁴ [REDACTED]



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Please call (202) 317-5197 if you have any further questions.