Office of Chief Counsel
Internal Revenue Service

memorandum

CC:MSR:ILD:CHI:TL-N-4254-99
GJStull

date: AUG 10 1999
to: District Director, Illinois District
Attn: Exam Division, Michael J. Welu, District Fraud Coordinator

from: District Counsel, Illinois District

subject: **Adjustment to Withholding Tax Credit through Examination**

This is in response to your request for advice dated July 7, 1999, on the issue of whether the Service, through an examination, can make an adjustment to a credit for income tax withholding reported on an individual's income tax return. The issue was further developed by telephone conference on July 20, 1999, and in a meeting on July 21, 1999.

You have asked this question concerning an individual who is an officer of a corporation which failed to file quarterly employment tax returns (Forms 941)and failed to deposit timely any withheld employment taxes. Despite these failures, the corporation issued Forms W-2 reflecting withheld income taxes for the officer-employee who then claimed an I.R.C. § 31 credit on his Form 1040:

Your request raises the following issues:

I. Whether the officer-employee is entitled to the credit under I.R.C. § 31 for income taxes withheld, despite the corporation's failure to deposit the taxes.

II. Whether the withholding credit is erroneous under these circumstances because the amounts were not actually withheld.

III. Whether the procedural remedy to an erroneous credit is an adjustment, through examination, to the individual's income tax liability.

By telephone conference on July 20, 1999, you raised the following additional issue:

IV. Whether the civil fraud penalty under I.R.C. § 6663 may be asserted in an appropriate case against the officer-employee for underpayment of income tax flowing from the erroneous credit.

Brief Answers

I. The failure of the corporation to pay over withheld taxes does not defeat a claim for the withholding credit by an officer-employee, provided the taxes have actually been withheld.

II. However, the credit for withheld taxes is erroneous if no withholding occurred.

III. Deficiency procedures do not apply to correct the erroneous withholding or other prepayment credit, but summary correction procedures are available to assess an erroneous refund of the prepayment credits under I.R.C. § 6201(a)(3). Examination of the income tax return by a revenue agent is an appropriate method of raising these issues, since neither revenue officers nor revenue officer examiners have jurisdiction to examine the income tax return of the individual. We recommend, however, that you attempt to establish a coordinated agreement between the division chiefs of examination, collection, and the criminal investigation division (CID) before initiating a project to develop these issues.

IV. Where the erroneous withholding credit or refund was due to fraud, the civil fraud penalty under I.R.C. § 6663 may apply.

Circumstances generating the request

Employment tax examiners are engaged in a compliance project to identify nonfilers of employment tax returns. They identify the nonfilers by reviewing a list of employer identification numbers reflected on Forms W-2 for which no corresponding Form 941 has been recorded. They then solicit the filing of the Forms 941 from the employer. After a period of time in which no response is received, the highly compensated employees whose names appear on the W-2's are identified in an attempt to identify the shareholders or officers in charge of the employer and particularly those who may have liability as responsible persons under I.R.C. § 6672 for unpaid employment taxes.

In some cases, the corporate employers are no longer in existence. In these instances, a fraud referral may be created.

As District Fraud Coordinator, you are interested in methods of assessment and collection, including the potential imposition of civil fraud penalties, that may be used against an individual who files a Form W-2 to report an income tax withholding credit when the filer, in control over the employer's payments of wages and tax deposits, knows that no such tax has been withheld or deposited.

Law and Regulations

I.R.C. § 31(a)(1) provides that "[t]he amount withheld as tax under chapter 24 [income tax withholding] shall be allowed to the recipient of the income as a credit against the tax imposed by this subtitle [subtitle A, income taxes]."

Section 1.31-1 of the Treasury Regulations provides in part that "[i]f the tax has actually been withheld at the source, credit or refund shall be made to the recipient of the income even though such tax has not been paid over to the Government by the employer."

I.R.C. § 3402(a)(1) provides in part that "[e]xcept as otherwise provided in this section, every employer making payment of wages shall deduct and withhold upon such wages a tax determined in accordance with tables or computational procedures prescribed by the Secretary... ."

I.R.C. § 6201(a) provides in part:

> The Secretary is authorized and required to make the ... assessments of all taxes (including interest, additional amounts, additions to the tax, and assessable penalties) imposed by this title ... Such authority shall extend to and include the following:
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> ***
>
> (3) Erroneous income tax prepayment credits. If on any return or claim for refund of income taxes under subtitle A there is an overstatement of the credit for income tax withheld at the source, or of the amount paid as estimated income tax, the amount so overstated which is allowed against the tax shown on the return or which is allowed as a credit or refund may be assessed by the Secretary in the same manner as in the case of a mathematical or clerical error appearing upon the return, except that the provisions of section 6213(b)(2) (relating to abatement of mathematical or clerical error assessments) shall not apply with regard to any assessment under this paragraph.

I.R.C. § 6203 provides that "[t]he assessment shall be made by recording the liability of the taxpayer in the office of the Secretary in accordance with rules or regulations prescribed by the Secretary. Upon request of the taxpayer, the Secretary shall furnish the taxpayer a copy of the record of the assessment.

Section 301.6203-1 of the Treasury Regulations provides in part: "The assessment shall be made by an assessment officer signing the summary record of assessment. The summary record, through supporting records, shall provide identification of the taxpayer, the character of the liability assessed, the taxable period, if applicable, and the amount of the assessment ... The date of the assessment is the date the summary record is signed by an assessment officer... ."

I.R.C. § 6211(a) provides that "[f]or purposes of this title in the case of income, estate, and gift taxes imposed by subtitles A and B and excise taxes imposed by chapters 41, 42, 43, and 44, the term 'deficiency' means the amount by which the tax imposed ... exceeds the excess of (1) the sum of (A) the amount shown as a tax by the taxpayer upon his return, if a return was made by the taxpayer thereon, plus (B) the amounts previously assessed (or collected without assessment) as a deficiency, over--(2) the amount of rebates, as defined in subsection [6211](b)(2), made."

I.R.C. § 6211(b)(1) provides that "[f]or purposes of this section [6211]--(1) The tax imposed by Subtitle A and the tax shown on the return shall both be determined without regard to payments on account of estimated tax, without regard to the credit under section 31, without regard to the credit under section 33, and without regard to any credits resulting from the collection of amounts assessed under section 6851 or 6852 (relating to termination assessments)."

I.R.C. § 6501(a) provides in part that "[e]xcept as otherwise provided in this section [6501], the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed... ."

I.R.C. § 6501(c)(1) provides that in the case of a false or fraudulent return with the intent to evade tax, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.

I.R.C. § 6501(c)(3) provides that in the case of the failure to file a return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.

Effective generally for returns due after December 31, 1989, I.R.C. § 6663(a) provides that "[i]f any part of any underpayment of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 75 percent of the portion of the underpayment which is attributable to fraud."

I.R.C. § 6664(a) defines "underpayment" for purposes of section 6663 as "the amount by which any tax imposed by this title exceeds the excess of--(1) the sum of--(A) the amount shown as the tax by the taxpayer on his return, plus (B) the amounts not so shown previously assessed (or collected without assessment), over (2) the amount of rebates made."

Treasury Reg. § 1.6664-2(a) provides in part that [i]n the case of income taxes imposed under subtitle A, an underpayment for purposes of ... section 6663, relating to the fraud penalty, means the amount by which any income tax imposed under this subtitle (as defined in paragraph (b) of this section) exceeds the excess of

(1) the sum of--

(A) the amount shown as the tax by the taxpayer on his return (as defined in paragraph (c) of this section), plus

(B) the amounts not so shown previously assessed (or collected without assessment)(as defined in paragraph (d) of this section), over

(2) the amount of rebates made as defined in paragraph (e) of this section."

Treasury Reg. § 1.6664-2(b) provides in part that "[f]or purposes of paragraph (a) of this section, the 'amount of income tax imposed' is the amount of tax determined under subtitle A for the taxable year determined without regard to

(1) the credits for tax withheld under sections 31 (relating to tax withheld on wages) and 33 (relating to tax withheld at source on nonresident aliens and foreign corporations);

(2) payments of tax or estimated tax by the taxpayer;

(3) any credit resulting from the collection of amounts assessed under section 6851 as the result of a termination assessment, or section 6861 as the result of a jeopardy assessment; and

(4) Any tax that the taxpayer is not required to assess on the return (such as the tax imposed by section 531 on the accumulated taxable income of a corporation)."

Treasury Reg. § 1.6664-2(c) provides in part that "[f]or purposes of paragraph (a) of this section, the 'amount of tax shown by the taxpayer on his return' is the tax liability shown by the taxpayer on his return, determined without regard to the

items listed in § 1.6664-2(b)(1), (2), and (3), except that it is reduced by the excess of--

(i) The amounts shown by the taxpayer on his return as credits for tax withheld under section 31 (relating to tax withheld on wages) and section 33 (relating to tax withheld at source on nonresident aliens and foreign corporations), as payments of estimated tax, or as any other payments made by the taxpayer with respect to a taxable year before filing the return for such taxable year, over

(ii) The amounts actually withheld, actually paid as estimated tax, or actually paid with respect to a taxable year before filing the return for such taxable year."

Treasury Reg. § 1.6664-2(d) provides in part that "[for purposes of paragraph (a) of this section, 'amounts not so shown previously assessed' means only amounts assessed before the return is filed that were not shown on the return ... [and] the amount 'collected without assessment' is the amount by which the total of the credits allowable under section 31 ... section 33 ... estimated tax payments, and other payments in satisfaction of tax liability made before the return is filed, exceed the tax shown on the return (provided the excess has not been refunded or allowed as a credit to the taxpayer)."

I.R.C. § 6665 provides:

(a) Additions treated as tax.

Except as otherwise provided in this title--

(1) the additions to the tax, additional amounts, and penalties provided by this chapter shall be paid upon notice and demand and shall be assessed, collected and paid in the same manner as taxes; and

(2) any reference in this title to "tax" imposed by this title shall be deemed also to refer to the additions to the tax, additional amounts, and penalties provided by this chapter.

(b) Procedure for assessing certain additions to tax.

For purposes of subchapter B of chapter 63 (relating to deficiency procedures for income, estate, gift, and certain excise taxes), subsection (a) shall not apply to any addition to tax under section 6651, 6654, or 6655; except that it shall apply

(1) in the case of an addition described in section 6651, to that portion of such addition which is attributable to a deficiency in tax described in section 6211; or

(2) to an addition described in section 6654 or 6655, if no return is filed for the taxable year.

I.R.C. § 6672(a) provides in part that "[a]ny person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over... ."

I.R.C. § 7501(a) provides that "[w]henever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States. The amount of such fund shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose."

If taxes were actually withheld, the credit is allowable.

Whether the officer-employee is entitled to the credit under I.R.C. § 31 for income taxes withheld but not deposited turns on whether the corporation actually withheld the taxes. Under section 1.31-1 of the Treasury Regulations, if the tax has actually been withheld at the source, the recipient's credit or refund is allowed even though such tax has not been paid over to the Government by the employer.

Section 1.31-1 properly recognizes the distinction between withholding (the collection of the funds from the wages of employees) and payment (the delivery of the withheld funds to the government. The employer (or other party legally in control of the payment of the wages) is primarily responsible to withhold the tax from the wage payment. I.R.C. § 7501(a) deems the amount withheld to be a special fund in trust for the United States, in essence making the withholder a trustee for the government. Recognizing that as soon as tax is withheld from the paycheck of the employee it is deemed to be in government hands, the regulation confers the credit or refund for the withheld amount whether or not the withholder subsequently pays over the money to

a federal depositary.

Thus, if the taxes were **actually withheld** by the corporation, the credit is available to the officer-employee even though the corporation failed to pay them to the Government. In that event, the appropriate remedy would be to pursue either the corporation for the taxes or pursue the responsible persons under the trust fund recovery penalty provisions of I.R.C. § 6672. An adjustment to the employee's individual tax liability based on denial of the credit would not be appropriate.

If the taxes were not withheld, the credit is erroneous.

I.R.C. § 31 only permits the credit for an "...amount withheld as tax...." If the amount was not actually withheld, the credit cannot apply. *Goins v. Commissioner*, T.C. Memo 1997-521, 74 T.C.M. (CCH) 1243 (1997), *aff'd per curiam*, 98-2 USTC ¶ 50,532 (4th Cir. 1998), *Edwards v. Commissioner*, 39 T.C. 78, 84 (1962), *aff'd on this issue* 323 F.2d 751 (9th Cir. 1963).

Technically, this applies not only to innocent employees, but also to employees in control of the wage payments and the withholding and reporting duties concerning the wages. However, innocent employees whose paychecks have been reduced in the amount of taxes withheld have a right to expect that the withheld taxes will be paid to the government and are necessarily the primary beneficiaries of the automatic allowance under Treas. Reg. § 1.31-1. In such cases, solid proof that withholding did not in fact occur would be required to defeat the withholding credit for an innocent employee.

On the other hand, if the person claiming the credit for withheld taxes is also the person charged with the duty to withhold and pay over the taxes, the failure to pay the taxes raises the issue as to whether withholding actually occurred. If the failure to pay the taxes is accompanied by a failure to file appropriate returns to report the withheld taxes, a stronger case of lack of withholding might be established.

What kind of evidence is relevant for determining whether withholding took place? One major fact that tends to negate withholding is that the deposit was never made. However, the employee may assert that even though the corporation never deposited the taxes, it nevertheless withheld them. For example, if funds were actually set aside from time to time into a separate payroll account, but the payroll account was raided by the corporation, the employee may be able to show that withholding took place notwithstanding the failure to deposit.

Another fact contradicting withholding is the failure to file quarterly employment tax returns to report the amounts withheld. If funds were intended to be segregated for withholding, an employer acting in good faith would at least report the withholding on timely filed employment tax returns whether or not timely deposits were made.

A fact that tends to demonstrate withholding is the reporting in income of the gross periodic wages rather than net wages by the employee. This fact is strengthened if paychecks or pay stubs prepared each pay period reflect the gross income that is ultimately included on the employee's income tax return. The creation of a Form W-2 after the payments is less persuasive as evidence of withholding since the value of the credit generated by withholding is greater than the tax cost generated by including it in the employee's gross income. However, if the government produces no contrary evidence (that withholding did not take place), the production of an unrebutted Form W-2 by a taxpayer has been sufficient to generate the credit. *Harrod v. Commissioner*, T.C. Memo. 1961-300, 20 T.C.M. (CCH) 1544 (1961).

The actions of the corporation with respect to other employees, if any, may produce significant evidence. Were there other employees for whom the corporation failed to withhold and deposit taxes? How were periodic payments reflected in the paychecks or statements to such employees?

A combination of the failure to file Forms 941, the failure to deposit withheld taxes, the claiming of credit for the taxes which he knew had not been withheld or paid, and inconsistent statements regarding these failures by the corporate president and sole shareholder of a closely held corporation resulted in the president's convictions for willful failure to collect or truthfully account for and pay over federal withholding taxes under I.R.C. § 7202 and willfully making and subscribing false income tax returns under I.R.C. § 7206(1). *United States v. Gollapudi*, 947 F.Supp. 768, (D. N.J. 1996) *aff'd*, 130 F.3d 66 (3d Cir. 1997), *cert. denied*, 118 S.Ct. 1190 (1998). This case demonstrates that the line between withholding of taxes from employees and the payment of the withheld tax to the government diminishes as the degree of control over withholding by the person claiming the credit increases. Therefore, it will be easier to establish a lack of withholding flowing from a failure to deposit, and hence an erroneous credit, where the employee who claims the credit is the employee charged with the withholding, deposit, and reporting duties.

The facts described above are, of course, not the only facts that may be relevant to determine a taxpayer's noncompliance. We will be pleased to work with you to identify other relevant and

material facts that will help you to develop viable cases in this area.

If the withholding credit has been overstated erroneously, the amount so overstated can be assessed as if it were a mathematical or clerical error without following the deficiency procedures.

Assuming that the failure to withhold can be established, and that the withholding credit under I.R.C. § 31 is erroneous, the income tax deficiency procedures do not apply for correcting the error with respect to the individual's tax return. Under I.R.C. § 6211, the withholding credit is not part of the deficiency computation. Thus, it cannot adjusted by issuance of a statutory notice of deficiency. Nor would it fall within the jurisdiction of the Tax Court in an individual income tax case. However, summary correction procedures are available for such an error.

Under I.R.C. § 6201(a)(3) the Secretary has the authority to assess an erroneous income tax prepayment credit, such as the withholding credit, in the same manner as a mathematical or clerical error appearing on the income tax return. Furthermore, the provisions of I.R.C. § 6312(b)(2) relating to abatement of the assessment upon timely request of the taxpayer do not apply to a "section 6201(a)(3) assessment".

The method for correcting the erroneous income tax prepayment credit depends on whether or not the amount has been refunded. If an amount has been refunded, the Secretary must assess the amount refunded under I.R.C. § 6201(a)(3). However, if no refund has occurred, and the amount has only been applied against the individual's current tax liability or credited to the individual (presumably to be applied to a subsequent year's tax liability), the current position of the Office of the Chief Counsel is that the error can be corrected administratively by reversing the credit in the internal account records without assessment.

Erroneous prepayment credit--refunded

A section 6201(a)(3) assessment must comply with the requirements of I.R.C. § 6203 and Treas. Reg. § 301.6203-1. *Gentry v. United States*, 962 F.3d 555 (6th Cir. 1992); *Howell v. United States*, 164 F.3d 523 (10th Cir. 1998). Under Treas. Reg. § 301.6203-1, the assessed liability must be included on a Summary Record of Assessment (Form 23C or RACS 006) which must be signed by an assessment officer. The date on which the officer signs the Summary Record of Assessment constitutes the date of

assessment. The internal account code used for a section 6201(a)(3) assessment should reflect a "payment" assessment rather than a "tax liability" assessment, if such a coding is available. After the assessment is made, notice and demand for payment of the amount should be issued under I.R.C. § 6303(a). Merely reversing the income tax prepayment credit on the taxpayer's account does not constitute a section 6201(a)(3) assessment.

The provisions of I.R.C. § 6501 imposing a period of limitations on assessment apply to a section 6201(a)(3) assessment. Although the Court of Claims had concluded in *DeRochemont v. United States*, 23 Cls. Ct. 80 (1991), that the period of limitations under I.R.C. § 6501 did not apply to a section 6201(a)(3) assessment, more recently it applied the section 6501(c) period to section 6201(a)(3) assessments in *Brister v. United States*, 35 Fed. Cl. 214 (1996), 77 AFTR 2d 96-1492. We believe the better view is the one expressed in *Brister*.

As a result, a section 6201(a)(3) assessment must generally be made within three years after the individual's income tax return was filed. An unlimited time to assess the tax applies under I.R.C. § 6501(c)(1) in the case of a false or fraudulent return with the intent to evade the tax. If the individual has filed timely his Form 1040 and the three year period has expired, the unlimited time to assess the tax may be established if the attachment of the Form W-2 showing the erroneous credit to the Form 1040 constitutes the filing of a false or fraudulent return with the intent to evade the tax.

Erroneous prepayment credit--not refunded

If the overpayment has not been refunded to the taxpayer, but has been applied only against the tax shown on the return or allowed as a credit (presumably to be applied against next year's tax liability), the Service need not assess the amount under I.R.C. § 6201(a)(3), but may simply reverse the credit. See H.R. Rep. 1337, 83rd Cong., 2d Sess A404 (1954); S. Rep. 1622, 83rd Cong., 2d Sess. 572 (1954). The Service is not legally obligated to grant credit for an amount claimed as a credit where it is known that the claimant had no withholdings. See, for example, IRS Legal Memorandum 199919031 (March 17, 1999), 1999 TNT 94-30.

Although this action is internal, the taxpayer must be notified of the action and provided a mechanism for contesting it. The filing of a Form 1040 with a Form W-2 that overstates the withholding credit is a claim for refund. Thus, the appropriate procedures to be followed are the refund denial procedures. An official notice of claim disallowance that

satisfies I.R.C. § 6532(a)(1) commences the two-year period of limitations for filing a refund.

Erroneous prepayment credit--partly refunded

If the erroneous prepayment credit has been partially refunded, the section 6201(a)(3) assessment procedures could be used for the entire overstated credit, even though the portion that has not been refunded could be reversed without assessment. In the alternative, the components of the overstated credit could be corrected independently, using the assessment procedures only for the amount refunded and the internal procedures for the amount not refunded.

Civil fraud penalty

Under I.R.C. § 6663, if any part of an underpayment of tax required to be shown on a return (due after December 31, 1989) is due to fraud, added to the tax is an amount equal to 75 percent of the portion of the underpayment due to fraud. Although this usually arises in a case involving a deficiency, the fraud penalty is not so limited. A fraudulent reporting of withholding or estimated tax credits may also generate an underpayment to which the section 6663 civil fraud penalty can apply.

I.R.C. § 6664 and Treas. Reg. § 1.6664-2 define underpayment for income tax purposes generally as the amount by which the income tax imposed exceeds the excess of (1) the sum of (i) the amount of tax shown as a tax by the taxpayer on his return plus (ii) amounts not so shown previously assessed (or collected without assessment) over (2) the amount of rebates made. This complicated statement is more simply expressed as a mathematical formula under section 1.6664-2(a):

Underpayment = W-(X+Y-Z)

W = the amount of income tax imposed;
X = the amount shown as a tax by the taxpayer on his return;
Y = amounts not so shown previously assessed (or collected without assessment); and
Z = the amount of rebate made.

For purposes of this computation, the amount of income tax imposed, W, is calculated without regard to the withholding credit, but the amount shown as a tax by the taxpayer on his or her return, X, is reduced by the excess of the amount shown by the taxpayer as his or her withholding credit over the amount actually withheld. Thus, if a taxpayer has reported on the Form 1040 more tax than was actually withheld, any underpayment will

be increased by that amount. As a result, where the elements of fraudulent underpayment of tax can be proven, a civil fraud penalty can be generated by falsely claiming an income tax withholding credit to which the taxpayer knows he or she is not entitled. The fraud penalty may be imposed for claiming false withholding credits even for taxable years in which no "deficiency" under section 6211 arises because the taxpayer has reported the correct amount of income tax liability on the return. *Sadler v. Commissioner*, 113 T.C. No. 4 (July 29, 1999); *Rice v. Commissioner*, T.C. Memo. 1999-65, 77 T.C.M. (CCH) 1488 (1999).

Under I.R.C. § 6665(a), the civil fraud penalty shall be paid upon notice and demand and shall be assessed, collected, and paid in the same manner as taxes. The underpayment of tax resulting from a false overstatement of a withholding credit results in an underpayment of income tax. Under section 6665(b), certain additions to tax are expressly excluded from the deficiency procedures, but the civil fraud penalty of section 6663(a) is not so listed. Therefore, a civil fraud penalty generated by a false overstatement of withholding credit should be processed under the deficiency procedures, *Rice v. Commissioner*, T.C. Memo. 1999-65, 77 T.C.M. (CCH) 1488 (1999), even though the underlying assessment to recover the erroneous prepayment credit is conducted summarily under section 6201(a)(3) without the deficiency procedures.

Note that the civil fraud penalty provisions under I.R.C. § 6663 and the definition of "underpayment" under I.R.C. § 6664 described in this memorandum apply to returns the due date for which is after December 31, 1989. We have not considered and express no opinion on the application of the civil fraud penalty provisions that were in effect for returns due on or before that date.

Alternative approaches

The benefit to the government in pursuing the individual who attached the Form W-2 to his Form 1040 under I.R.C. § 6201(a)(3) is the summary procedure available to recover the erroneous refund and the potential for applying the civil fraud penalty. However, in some cases, an erroneous refund suit may be a better alternative. In other cases, pursuit of the employer directly or a responsible person under the trust fund recovery penalty provisions of I.R.C. § 6672 may be preferable.

Erroneous refund suit

The amount to be recovered from an individual employee could be recovered as an erroneous refund under I.R.C. § 7405 within

the period of limitations (2 years after the making of the refund or 5 years thereafter with fraud or misrepresentation of a material fact) under I.R.C. § 6532(b). One advantage of an erroneous refund suit to recover a fraudulently obtained refund is the ability of the government to recover not only the erroneous tax but also any overpayment interest it may have allowed on the refund. It may not summarily assess the overpayment interest, but may recover it in a refund suit. *United States v. Steel Furniture Co.*, 74 F.2d 744 (6th Cir. 1935). The disadvantage is that even if fraud can be proven, the statute of limitations precludes recovery through an erroneous refund suit if the 5-year period has expired.

Pursuing the employer and responsible persons under I.R.C. § 6672.

Another method of recovering the erroneous refund is to seek the amount of unpaid withholding tax from either the employer itself or the responsible person under the trust fund recovery penalty provisions (TFRP) of I.R.C. § 6672. This may be most useful in a case in which no Form 941 returns have been filed. Absent the filing of the Form 941 returns, the period of limitations for assessing the delinquent employment taxes, including the withholding taxes under Chapter 24, does not begin to run. The period of time to assess the trust fund recovery penalty against a responsible person generally tracks the period of limitations for the underlying return on which the employment taxes were reported. See *Zeller v. United States*, 97-1 USTC ¶ 50,116 (N.D. Il. 1996).

From 1993 to 1995, the Service began to abandon its 30-year old historical view on the application of the general employment tax limitations period under I.R.C. § 6501 to the TFRP and tested a more aggressive position--that **no** period of limitations applied to the TFRP **even where the employer had timely filed the employment tax returns**, Forms 941. This position was based on a theory that no return reports the TFRP because the penalty arises independently of the provisions which impose the employment taxes and because the Form 941 is insufficient to report all of the information necessary to make a TFRP assessment. These arguments were rejected by the courts (see, for example, *Lauckner v. United States*, 68 F.3d 69 (3d Cir. 1995)) and are no longer being advanced by the Service. Action on Decision 1996-006 (July 15, 1996).

For trust fund recovery penalties assessed after July 30, 1996, a special statute of limitations provision and 60-day pre-assessment notice provision were enacted in the Taxpayer Bill of Rights 2, Pub. L. 104-168, Sec. 901(a), 110 Stat. 1452, 1465.

This special statute of limitations provision under I.R.C. § 6672(b) operates in conjunction with the general period of limitations under I.R.C. § 6501.

In summary, the TFRP can be assessed against a responsible person within the period of limitations commenced by the filing of the employer's Form 941. Thus, it generally must be assessed within the 3-year period following the statutory date on which the Form 941 is deemed filed (April 15 of the succeeding calendar year). On the other hand, if no Form 941 has been filed for a calendar quarter, the TFRP with respect to that period may be assessed at any time.

Practical implications of the alternatives

Whether or not one or more alternative approaches described above may be legally applicable to a particular case, we must also consider procedural issues concerning case development. Due to internal restrictions on scope of authority, a revenue officer (RO) does not have jurisdiction to examine tax returns. A revenue officer examiner (ROE) has jurisdiction to examine only employment tax returns. Thus, if the issue is discovered by an RO or ROE, a civil referral can be made to the Examination Division (and, if criminal fraud is suspected, a referral to the Criminal Investigation Division (CID). The division receiving the referral will use its discretion as to whether to apply its resources to pursue the case.

These practical limitations make a joint agreement between the divisions to develop the issue a favored alternative to the traditional referral system. We recommend that you contact the respective division chiefs if you desire to develop a project in this area.

Conclusions

Income taxes withheld at the source by an employer generate a credit under I.R.C. § 31 for an employee whether or not the employer pays them over to the government. However, they must have actually been withheld.

If the employee claiming the credit is also the employee of the employer charged with responsibility for withholding, an issue arises whether the amounts were, in fact, withheld. The facts and circumstances of the individual case must be analyzed.

If no withholding occurred and the credit is erroneous, a summary assessment procedure can be used under I.R.C. § 6201(a)(3) to recover the overpaid credit or refund from the employee, provided the period of limitations to assess the

tax has not yet expired.

Alternatively, the overpayment may be obtained from the employee through an erroneous refund suit or, in some cases, by pursuing the employee as a responsible person under the trust fund recovery penalty provisions of I.R.C. § 6672. The choice of recovery mechanisms depends on which periods of limitations may bar one or more of the actions and on the strength of evidence necessary to prove the application of one or more of the approaches.

The fraud penalty under I.R.C. § 6663 may be applicable in an appropriate case involving the false claim for credit or refund of withholding taxes that were not, in fact, withheld. The deficiency procedures apply to this fraud penalty assertion, notwithstanding that the amount upon which the fraud penalty is calculated is recovered by assessment outside of the deficiency procedures.

Of course, the strongest cases for applying the summary assessment procedures and the fraud penalty against an individual will demonstrate facts that may sustain a criminal action. A convergence of multiple years of failure to file 941 returns, failure to deposit withheld taxes, and the attachment of Forms W-2 by the individual who knows that neither the reporting nor withholding took place provide a strong basis for commencing an examination with a view toward proceeding against the individual's income tax liability either in lieu of or in addition to proceeding against him as a responsible person under the trust fund recovery penalty provisions. We will be pleased to work with you to develop criteria for determining which cases should be processed in this fashion.

Finally, since revenue officers and revenue officer examiners do not have authority to examine income tax returns, an income tax examination by a revenue agent is the appropriate method of raising the issue of the individual's tax liability generated by the false Form W-2. Under current procedures, whenever the RO or ROE encounters the potential of a false W-2, a referral to the Examination Division (and, if appropriate, to CID) can be made. However, this device has not been used frequently. We believe that, consistent with the forthcoming reorganization of the Service and with a view to blending different Service functions for more efficient tax administration, a cooperative approach between examination, collection, and CID should be developed to pursue these issues as resources permit.

If you have any questions, or would like additional information, please contact Gregory J. Stull at (312) 886-9225 ext. 342.

RICHARD A. WITKOWSKI
District Counsel

By: _____
Gregory J. Stull

cc: Chief, Examination Division
Chief, Collection Division
Chief, Criminal Investigation Division