Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Associate Area Counsel (Salt Lake City)
(Small Business/Self-Employed)
CC:SB:5:SLC

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CC:PA:APJP

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subject: 6702 Farming Income Credit

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

This responds to your request for review of a draft service center advice dated May 13, 2004.

You have described a situation in which certain taxpayers are amending their federal income tax returns to exclude proceeds received in settlement of a lawsuit where, it appears, plaintiff-taxpayers recovered on a claim of discrimination

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For your convenience, our discussion addresses the issues analyzed in your memorandum.

<u>Discussion of I.R.C. § 104</u>

In the section of your draft memorandum discussing I.R.C. § 104(a)(2), we recommend that you delete all language after you set forth the language of I.R.C. § 104(a)(2) and substitute instead the following:

> The requirement that damages must be received on account of personal physical injuries or physical sickness applies to amounts received after August 20, 1996. *See* § 1605 of the Small Business Job Protection Act of 1996. Here all of the payments were made well after 1996. Thus, we believe that you should assert that the plaintiffs simply cannot demonstrate that they received their damages "on account of," or in other words, in compensation for, "personal physical injuries or physical sickness."

For questions related to this issue, please contact CC:ITA:Br4, at (202) 622-4920.

Application of I.R.C. § 6702

We agree with your conclusion that it is inappropriate to impose a section 6702 frivolous return penalty in these cases. Section 6702(a) provides in relevant part that if an individual files what purports to be an income tax return but that "contains information that on its face indicates that the self-assessment is substantially incorrect," and the conduct is due to a position that is frivolous, the individual will pay a penalty of $500. Although often applied when frivolous positions are taken on original returns, the frivolous return penalty applies equally to amended returns. Colton v. Gibbs, 902 F.2d 1462, 1464 (9th Cir. 1990); Branch v. Internal Revenue Service, 846 F.2d 36, 37 (8th Cir. 1988); Stelly v. Commissioner, 804 F.2d 868, 870 (5th Cir. 1986) (per curiam); Sisemore v. United States, 797 F.2d 268, 270 (6th Cir. 1986).

As your draft memorandum notes, these claims for refund are substantially different from the types of positions that are generally thought of as "frivolous" – e.g., constitutional arguments against paying income tax (Bearden v. United States, 575 F. Supp. 1459 (D. Utah 1983)), and arguments that wages are not taxable income (Loofbourrow v. United States, 208 F.Supp.2d 698 (S.D. Tex. 2002)). We agree that, in the situation you describe, the position that excluding proceeds received in settlement of a racial discrimination suit does not rise to the level of "frivolous."

Application of I.R.C. § 6501(c)

We agree with your conclusion that the IRS may not rely on the unlimited statute of limitations in I.R.C. § 6501(c) to make an assessment after the expiration of the normal three-year statute of limitations. Given the facts you presented, however – specifically, that the claim for excluding the settlement proceeds is made on an amended, rather than original, return – it is not necessary to reach this issue. "[W]hen Congress provided for assessment at any time in the case of a false or fraudulent 'return,' it plainly included by this language a false or fraudulent original return." Badaracco v. Commissioner, 464 U.S. 386, 393 (1983) (emphasis in original). The Supreme Court emphasized this point by again stating that "it is plain that 'the return' referred to in § 6501(a) is the original, not the amended, return." Id. at 396.

Validity of the Return and Whether It Is Processible

Generally, we believe that the advice provides an adequate response. However, we note that in the discussion regarding I.R.C. § 6611(g), the advice states that a return is not processible until four criteria are met. The advice inaccurately states that one of the statutory criteria (item 4) is that "the taxpayer submits, in good faith, sufficient required information (whether on the return or on required attachments) to permit the mathematical verification of the tax liability shown on the return." This statement is mostly a verbatim recitation of section 6611(g)(2)(B)(ii); however, the statute does not explicitly provide for a "good faith" requirement. The "good faith" requirement is a condition that generally has been read into the Code by the Courts. See, e.g., The Columbia Gas System, Inc., v. United States 70 F.3d 1244, 1246 (Fed. Cir. 1995). Accordingly, we recommend that the discussion regarding section 6611(g) be revised by quoting the statutory language verbatim and removing the reference to the "good faith" requirement.

Nevertheless, we agree with the conclusion that the IRS should treat these returns as processible, since the returns meet all of the statutory criteria under section 6611(g). We also agree that the IRS might be able to make an argument that the taxpayers did not submit the returns in good faith, relying on the cited cases, but that the question of good faith should be considered in the context of determining the validity of the return rather than whether the return is processible.

A draft revised discussion is attached to this memorandum.

For questions relating to this issue, please contact
CC:PA:APJP:Br1, (202) 622-4910.

Recovery of an Erroneous Refund and Collection Actions

The facts in your draft memorandum describe the relevant original and amended return entries. They do not, however, indicate the terms of the settlement and consent decree regarding the taxability of the settlement benefit and the tax payment by the Department of Agriculture. The consent decree, 185 F.R.D. 82, at 108-109 (D. D.C. 1999), provides that for those who select the $50,000 payment and loan forgiveness, the USDA will also make a tax payment to the IRS of 25% of the cash payment and loan forgiveness. Thus, it is clearly contemplated by the settlement and consent decree, to the point of being a term of the settlement and consent decree, that the cash payment and loan forgiveness are taxable income to the individual receiving the benefit of the settlement.

We recommend adding to the facts a statement consistent with the foregoing. We recommend deleting portions of the analysis that address the basis for the discrimination claim and that appear irrelevant to this aspect.

Issue 4 (addressing erroneous refunds), as currently drafted, to some extent confuses three separate concepts: (1) the immediate action to prevent the payment of – or, if

payment has already been made, to recover (without a formal determination of liability) -- a refund induced by a false or fraudulent refund claim; (2) the determination of a liability, whether by deficiency, in an erroneous refund action, or in another court action; and (3) the collection of such a determined liability. The second of these, determining a liability (if immediate recovery proves unavailing), is best dealt with as issue 4, while issue 6 (addressing collection actions) is the proper place to address recovery before a determination of liability, as well as collection after a determination of liability.

A draft revised discussion of these issues is attached to this memorandum.

Please contact CC:PA:CBS:Br3, at (202) 622-3630 for questions related to these issues.

Referral of the Return Preparer for Investigation

The section 6694 penalty generally does not apply if: (1) the position that results in an understatement of liability has at least a "realistic possibility" – i.e., a one-in-three – chance of success; or (2) the position that results in an understatement of liability is not frivolous and is disclosed. I.R.C. § 6694(a). The penalty under I.R.C. § 6694 is $250 for each return or claim for refund that does not meet either of these two requirements. Id. There is a reasonable cause exception for this penalty. Id. The position that the settlement proceeds are excludible from gross income may be an incorrect position, but it is likely not a frivolous one.

"Disclosure" in this context has the meaning given by I.R.C. § 6662(d)(2)(B)(ii), which requires adequate disclosure either in the return (or claim for refund) or in a statement attached to the return (or claim for refund). Disclosure is adequate only if made either on a properly completed Form 8275 (Disclosure Statement) (or on a Form 8275-R (Regulation Disclosure Statement) if the position is contrary to a regulation). Disclosure made on the return (or claim for refund) without the Form 8275 or 8275-R may also be adequate if it is in accordance with Rev. Proc. 2002-66, 2002-2 C.B. 724 (the annual revenue procedure referred to in the regulations). Treas. Reg. § 1.6662-4(f). The revenue procedure states that the following amounts shown on a Form 1040 may constitute adequate disclosure for purposes of I.R.C. §§ 6662 and 6694: (1) certain itemized deductions; (2) certain trade or business expenses; (3) certain amounts reflected on a Schedule M-1 (Reconciliation of Income (Loss) per Books with Income per Return); and (4) certain other expenses.

The exclusion of income under I.R.C. § 104 is not mentioned in Rev. Proc. 2002-66. Nor does it appear from the facts presented that taxpayers are claiming the exclusion of the settlement proceeds on their Forms 1040. Therefore, we do not believe that the disclosure provisions in Rev. Proc. 2002-66 would apply in these cases.

There are no facts that indicate the position is disclosed on a Form 8275 attached to the claim for refund. Therefore, it may be appropriate to consider the imposition of penalties against preparers of these claims for refund.

You have presented no facts indicating that the exclusion of settlement proceeds is something that has been “promoted” or “marketed” to taxpayers. Therefore, we express no opinion on the applicability of promoter penalties in these cases.

Please contact CC:PA:APJP:Br2, (202) 622-4940 if you have any questions.

ATTACHMENTS

Is the Return Valid and Processible?

The determination of whether a return qualifies as processible depends on the criteria set forth in I.R.C. § 6611, regarding interest on overpayments. Section 6611(a) generally provides that interest shall be allowed and paid upon any overpayment in respect of any internal revenue tax. Section 6611(b)(3) and (e) generally require that a return be filed before a taxpayer is eligible to receive interest on an overpayment.

Section 6611(g)(1) provides that for purposes of section 6611(b)(3) and (e), a return shall not be treated as filed until it is filed in processible form.

Section 6611(g)(2) provides that for purposes of section 6611(g)(1), a return is in a processible form if (A) such return is filed on a permitted form, and (B) such return contains (i) the taxpayer’s name, address, and identifying number and the required signature, and (ii) sufficient required information (whether on the return or on required attachments) to permit the mathematical verification of tax liability shown on the return.

The documents submitted for our review would meet all of the statutory requirements for processing. However, in addition to the statutory requirements recited above, the Courts have also generally required that the returns be filed by the taxpayer “in good faith.” For example, in The Columbia Gas System, Inc. v. United States, 70 F.3d 1244, 1246 (Fed. Cir. 1995), the Court of Appeals for the Federal Circuit stated that:

> Mathematical verifiability requires sufficient information to permit IRS to recalculate and corroborate the mathematics and data reported by the taxpayer. Thus, under section 6611, a taxpayer must submit, in good faith, all the required forms with the required signatures and enough underlying data for the IRS to verify the tax liability shown on the return. The information must be sufficient to enable IRS to calculate the tax liability without undue burden.

In this case, the taxpayers have arguably not followed the instructions for the forms, and they have *improperly excluded from income the settlement proceeds obtained through discrimination litigation*. While the IRS might have a valid argument that the taxpayers did not submit the returns in good faith, we recommend that the IRS treat the returns in

question as processible. However, the IRS may still raise the issue of good faith in the context of determining the validity of the return.

In this context, the Courts have identified four key criteria for evaluating the validity of a return. These four criteria are as follows:

1) There must be sufficient data to calculate tax liability;

2) The document must purport to be a return;

3) There must be an honest and reasonable attempt to satisfy the requirements of the tax law; and

4) The taxpayer must execute the return under penalties of perjury.

Beard v. Commissioner, 82 T.C. 766, 777 (1984), aff'd per curiam, 793 F.2d 139 (6th Cir. 1986). These four criteria are generally known as the Beard formulation or the "substantial compliance" standard, which is derived from a line of Supreme Court cases, including Zellerbach Paper Co. v. Helvering, 293 U.S. 172 (1934), and Florsheim Bros. Drygoods Co. v. United States, 280 U.S. 453 (1930). These cases hold that if a return meets the "substantial compliance" standard, the return is a valid return for purposes of the statute of limitations on assessment. This determination is based on the facts and circumstances of each case. Accordingly, no "bright line" test exists to determine whether a taxpayer has filed a valid return.

Given the facts of this case, we believe it would be prudent for the IRS to process the returns and treat the returns as valid, unless the IRS is able to obtain subjective evidence that clearly shows that the taxpayers filed the returns in bad faith. The attachment of correspondence to the returns does not change this analysis.

ISSUES RELATING TO ERRONEOUS REFUNDS AND COLLECTION

Issues

1. What process should the IRS follow to determine a liability (e.g., deficiency or other, including by a court) to recover erroneous refunds?

2. Would the IRS need to use the notice of deficiency procedures, and if so, how should the IRS treat the deletion of income found in the amended return?

3. If the IRS has made an erroneous refund (whether by credit, electronic funds transfer or mailed check), what actions may the IRS take to protect the revenues from immediate harm, to recover a refund as misappropriated government property, or to collect a determined liability?

Conclusions

1. There are two methods for determining a liability under the facts presented. One is to follow the deficiency procedures. The other is to follow the erroneous refund suit procedures of I.R.C. § 7405. Because of the greater efficiency which the notice of deficiency procedures provide, we recommend that the IRS use those procedures. The general period of limitations is three years from the date the original return is filed. To secure a determination of liability through erroneous refund litigation, the erroneous refund suit must normally be brought within two years of the refund, but where the taxpayer induced the making of the erroneous refund by fraud or misrepresentation of material fact, the government must bring an action under IRC § 7405 within the 5 year period of IRC § 6532(b).

2. We recommend the use of a notice of deficiency if the IRS has issued an erroneous refund. The IRS would need to treat the $50,000 of settlement proceeds as an income adjustment in the notice of deficiency.

3. Before a liability is determined, and before the erroneous refund is received or before it becomes a final payment, the IRS can always, subject to applicable time limits: (a) cause Financial Management Services (FMS) to stop issuance of an EFT or check; (b) cause the United States Postal Service (USPS) to prevent delivery and return a mailed check; and (c) cause a Stop Payment of an EFT or check. The IRS can also request voluntary repayment of an erroneous refund. Once the refund becomes a final payment, the deficiency procedures or the erroneous refund suit procedures may be used to determine liability. However arrived at, after a liability is determined, the IRS has administrative procedures for assessment and collection if the liability is a deficiency, and the government has judgment collection procedures if the liability (whether deficiency or erroneous refund) is reduced to judgment. In a case in which a misrepresentation of material fact occurred which warrants equitable protection of the revenues, and in conjunction with action to determine a liability, the government can

bring a suit requiring the taxpayer to turn over funds or property, and account for any funds not turned over.

Discussion

Recovery of an erroneous refund

Recovery Before Determination of a Collectible Liability

Without establishing any reason at all for recovery, the IRS as the authorizer or issuer of a payment can recover in the following ways.

One way is to cancel payment. If the IRS discovers that it erroneously issued a voucher to Financial Management Services (FMS) directing FMS to issue a payment (whether by EFT or check), the IRS within a very short period of time after issuing the payment voucher (10 days for a check and three days for an EFT, measured from FMS's receipt of the voucher) can cause (by issuing a canceling voucher) FMS to stop issuance of the EFT or check before it leaves the FMS facility.

Another way is to request a Mail Stop. If an erroneous refund is discovered after the refund check is put in the hands of the United States Postal Service (USPS), the IRS can submit an expedited request (by a Mailgram or an Express Mail letter) to any USPS post office identifying the mail-piece and the Treasury Department (IRS) as the sender. This procedure is provided in USPS Domestic Mail Manual (Issue 56 plus Postal Bulletin changes through PB22047, 4-5-01) D030 1.2. If the USPS is able to locate the mail item in its hands before delivery, the mail item will be returned to the IRS.

Another way is to issue a Stop Payment order. During the period before the erroneous refund is considered made (as a final payment, whether in regard to an EFT or check), the IRS or FMS can issue a Stop Payment on the EFT or check. The Stop Payment can be issued to a specific bank or to a small group of banks at any time during the period before completion of the Treasury first review, the time at which a payment becomes final. United States v. Commonwealth Energy System & Sub Cos., 235 F.3d 11 (1st Cir. 2000).

If it is too late for any of these loss-prevention measures, the IRS may attempt to recover the erroneous refund without a liability determination but with assertion of grounds for recovery by requesting voluntary repayment. If the refund is in the hands of the taxpayer, the IRS can contact the taxpayer and ask for voluntary repayment of the erroneous refund and the filing of an amended return. The communication from the IRS should explain the reason why the claim of the credit is not allowable.

Recovery Through Determination of a Collectible Liability

If the IRS has issued an erroneous refund, the IRS will have two options. The IRS can audit the taxpayer for the tax year and issue a notice of deficiency. Alternatively, the IRS can ask the Department of Justice to initiate an erroneous refund action to recover the refund. If the assessment statute remains open and no special enforcement situation exists, the IRS should engage the audit procedure followed by issuance of a notice of deficiency. This will best use the resources of the IRS and allow the IRS to access its administrative tools to collect the amount assessed, following default by the taxpayer or a determination by the Tax Court, before invoking judicial collection remedies.

If the deficiency procedures do not apply, or if you have a special enforcement reason to bring a suit, or if the statute of limitations for issuing a statutory notice of deficiency has expired, the IRS could also authorize an erroneous refund action pursuant to I.R.C. § 7405. If the action is brought, the IRS would need to coordinate with the Department of Justice on the collection of any judgment obtained.

Regarding the statute of limitations, normally the IRS has three years from the filing of a return in which to issue a notice of deficiency. I.R.C. § 6501(a). For erroneous refunds, the IRS could initiate an erroneous refund suit pursuant to I.R.C. § 7405 within the two-year period of I.R.C. § 6532(b). This two-year period runs from the making of the erroneous refund. For recovery of erroneous refunds the making of which was induced by misrepresentation of material fact, however, the IRS can rely on the 5 year period of section 6532(b) running from the making of the erroneous refund, which is defined as the completion of the Treasury Department's first review. See United States v. Commonwealth Energy System & Sub Cos., 235 F.3d 11 (1st Cir. 2000).

Finally, in cases involving misrepresentation of material fact (suggested by the instant facts) which warrant an equitable remedy, and in conjunction with action to determine a liability (such as filing of an erroneous refund action at the same time), the government can request that a court order the taxpayer to turn over to the court or the IRS funds or property, and account for any funds not turned over. This method was successfully used in United States v Crystal Foster, 2002 TNT 233-5 (4th Cir. 2002) aff'g 2002 TNT 60-15 (E.D. Va. 2002) (district court ordered turn-over of proceeds of the erroneous refund, turn-over of property into which the erroneous refund was translated, and an accounting for proceeds not turned over; separately, the district court found that the refund was erroneous).

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Please call 202 622-4940 if you have any further questions.