Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **200504028**

Release Date: 1/28/05

CC:PA:APJP:B02 [redacted] [
POSTN-113036-04

UILC: 6702.00-00, 6702.01-00, 6611.09-00, 7405.00-00

date: June 03, 2004

to: Mark H. Howard
Senior Counsel
(Small Business/Self-Employed)
CC:SB:5:SLC

from: Blaise G. Dusenberry
Special Counsel, Administrative Provisions & Judicial Practice
(Procedure & Administration)
CC:PA:APJP

subject: Advice on §6702 and its application to returns claiming a foreign income exclusion

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

This memorandum responds to your request for advice on a draft opinion related to returns in which the taxpayer inappropriately claimed a foreign income exclusion.

You have described a situation in which certain taxpayers are claiming refunds by using Form 2555 (Foreign Earned Income) or Form 2555-EZ (Foreign Earned Income Exclusion) to claim a foreign earned income exclusion under section 911 of the Internal Revenue Code. When completing these forms, however, these taxpayers indicate domestic addresses on lines for the taxpayer's "foreign address" and for the employer's "foreign address."

For your convenience, our discussion will address each of the issues analyzed in your memorandum.

<u>Issue 1:</u> Application of I.R.C. § 6702

We agree with your discussion and conclusion that the frivolous return penalty of section 6702 may apply to 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. Rev. Rul. 2004-28, 2004-12 I.R.B. 624, notes that the Service may impose the section 6702 penalty on taxpayers who attempt to exclude income earned in a state or territory of the United States.

Issue 2: Is the Return Valid and Processible?

Generally, we believe that the advice provides an adequate response. We note, however, that in the discussion regarding section 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., 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.

We also note that on page 5 of the advice, a reference is made to "Zellerbach Paper Co. v. Helvering, supra. " However, we were unable to locate the previous citation to this case in the advice. Accordingly, we would recommend that this reference be changed to Zellerbach Paper Co. v. Helvering, 293 U.S. 172 (1934).

A suggested revision to the analysis of this issue is included as an attachment to this memorandum. See attachment.

Issue 3: Recovery of an Erroneous Refund

Erroneous refunds can be separated into two categories: (1) rebate erroneous refunds and (2) nonrebate erroneous refunds. "Rebate refunds are issued on the basis of a substantive recalculation of a taxpayer's tax liability, e.g., the amount of tax due is less than the tax shown on the return." Acme Steel Co. v. Commissioner, T.C. Memo. 2003-188. A rebate erroneous refund occurs when the IRS incorrectly reduces or abates the taxpayer's tax liability to an amount that is less than that shown on the taxpayer's return. See IRM 4.19.1.5.14; SCA 200137051. "Nonrebate refunds are sent to the taxpayer not because the IRS determines that the tax paid is not owing but because of mistakes, typically clerical or computer errors." Henderson v. United States, 95 F. Supp. 995, 1002 n.19 (E.D. Wis. 2000) (citing O'Bryant v. United States, 49 F.3d 340, 342 (7th Cir. 1995). Because they involve determinations of a taxpayer's tax liability, rebate refunds can be recovered either through deficiency procedures or through action for recovering erroneous refunds. Nonrebate refunds, on the other hand, can be recovered only through an action for recovering erroneous refunds.

The draft memo correctly notes that when using the deficiency procedures to recover a rebate erroneous refund, the applicable statute of limitations for the return under section 6501 governs. In the case of an original return that is fraudulent, there would be an unlimited statute of limitations under section 6501(c)(1). We disagree with the conclusion, however, that erroneous refunds in this type of case should be characterized as "rebate" erroneous refunds. In these cases, the tax shown on the return will be zero. Any refund the IRS makes will be based on what the taxpayer has already paid compared to the purported tax liability of zero. Because the IRS would not be making a downward adjustment in the taxpayer's tax liability in these cases, but would instead be relying on the tax liability shown on the return, an erroneous refund under the facts presented would likely not be a rebate erroneous refund. Therefore, these erroneous refunds would not be recoverable using deficiency procedures.

As a general matter, we are also reluctant to identify these returns as per se fraudulent. Although the majority of the fraud cases deal with either failure to report income or failure to file returns, a return can also be fraudulent if deductions are overstated. See, e.g., Neaderland v. Commissioner, 52 T.C. 532 (1969), aff'd, 424 F.2d 639 (2d Cir. 1970) (underpayment of taxes resulting from the taxpayer's overstatement of business deductions was due to fraud); Toussaint v. Commissioner, 743 F.2d 309 (5th Cir. 1984), aff'g T.C. Memo. 1984-25 (theft loss deduction for nonexistent Picasso painting was due to fraud).

Fraud should not be asserted, however, where the taxpayer did not intend to deceive. See Raley v. Commissioner, 676 F.2d 980 (3d Cir. 1982) (where taxpayer told everyone involved in the collection process that he was not going to pay his taxes, court found there was no attempt at deceit); Muste v. Commissioner, 35 T.C. 913 (1961) (taxpayer who informed IRS each year of refusal to pay taxes was not liable for fraud penalty). Fraud requires a determination that a taxpayer intended to evade tax and "is never imputed or presumed." Toussaint, 743 F.2d at 312.

The draft memo cites Ballard v. Commissioner, 740 F.2d 759 (8th Cir. 1984), for the proposition that the purpose of the unlimited statute of limitations on a false or fraudulent return is due to the difficulty in identifying deficiencies caused by fraudulent or deceptive conduct and documents. In Ballard, the court stated, "The lifting of the normal statute of limitations addressees the difficulties which sometimes arise in the discovery of deficiencies by virtue of taxpayer fraud; the source of the fraud does not alleviate such difficulties in the case of a joint-filing spouse who did not personally intend to deceive the government." Ballard at 663. We agree with this general statement, but do not think Ballard provides a proper analogy to the situation in which a taxpayer claims a foreign income exclusion on the face of their return. In Ballard, the taxpayer engaged in a pattern of underreporting income, failing to report his business activities, and failing to maintain adequate records of business activities. This type of conduct falls within the type of deception noted above.

The draft memo cites Brister v. United States, 35 Fed.Cl. 214 (1996), to support the proposition that the section 6501(c)(1) unlimited statute of limitations can apply in an erroneous refund suit based on a notice of deficiency, which, as noted above, is likely not the case in the situation addressed by this memorandum. Although we agree generally with the proposition, we note that Brister did not involve an action by the government for the recovery of an erroneous refund. In that case, the taxpayer filed claims for refund for amounts that were never actually withheld. The IRS attempted to make adjustments to the taxpayer's 1985 and 1986 accounts in 1993, but the taxpayer argued that the statute of limitations on assessment had expired. The government argued that by filing Forms W-2 showing amounts that would never be paid, the taxpayer filed a false or fraudulent return with the intent to evade tax. In finding that the returns were false with the intent to evade tax, the court held that the assessments in 1993 were timely under section 6501(c)(1).

The draft memo also relies on Mullikin v. United States, 952 F.2d 920 (6th Cir. 1991). Mullikin, however, involved the imposition of a section 6701 penalty (aiding and abetting the understatement of tax liability) on an accountant and whether the five-year statute of limitations under 28 U.S.C. § 2462 applied to the assessment of that penalty.

The revenue ruling cited in the draft memo – Rev. Rul. 2004-28 – merely states that fraud is one of the *potential* civil penalties that taxpayers may face if they claim tax benefits on their returns as describing in the ruling. While it does put taxpayers on notice that this penalty may be sought, we do not believe that it should be inferred from the ruling that the IRS will treat every such return as fraudulent with intent to evade tax.

As a general matter, we recommend that Chief Counsel Advice ("CCA") not be cited as precedent. CCAs are "not official rulings or positions of the Service and, accordingly, are not and should not be used or cited as precedent." CC-2002-026, Q&A-21.

For the sake of completeness, we note that the reference to section 6501(c)(2) on page 5 of the draft memo does not apply to the foreign income exclusion cases referred to in the advice. Section 6501(c)(2) applies to willful attempts to evade taxes other than income taxes (subtitle A) or estate and gift taxes (subtitle B).

Because of the subjective nature of the "intent to evade tax" language in the definition of fraud (see, e.g., Toussaint, 743 F.2d at 312 (fraud "is never imputed or presumed," a court should not find fraud where the evidence shows "at most only suspicion")), we recommend that other options be explored before relying on an unlimited statute of limitations. In cases where an erroneous refund is generated because a taxpayer inappropriately claimed a foreign income exclusion, however, the extended 5-year period for bringing a suit to recover an erroneous refund may be considered.

Even in situations where the deficiency procedures are not available for recovering an erroneous refund, the government may recover the erroneous refund through a suit under section 7405. Generally, such a suit must be brought within two years after the refund is made. Section 6532(b). If, however, "any part of the refund was induced by fraud or misrepresentation of a material fact," the time for bringing suit is extended to five years. Section 6532(b).

In interpreting what standard is required for the five-year statute to apply, the Fourth Circuit in Lane v. United States, 286 F.3d 723, 732 (4th Cir. 2002), aff'g in part and rev'g in part Estate of Powell v. United States, 271 F. Supp. 2d 880 (W.D. Va. 2001), concluded that "the statutory term 'misrepresentation' in § 6532(b) lies somewhere in between the words 'misstatement' and 'fraud' on a scale of increasing culpability," and held that "the United States need not demonstrate more than gross negligence in order to avail itself of § 6532(b)'s five-year limitations period." In Lane, the executor of a widow's estate had filed claims for refund for almost $800,000, claiming that payments from the widow's deceased husband to his friend and former secretary were payments for compensation and were not gifts. The court found the executor/trustee's misrepresentations to be "grossly negligent at best and almost certainly reckless." Id. at 732. (The United States did not allege fraud in this case.)

In some extraordinary cases and in conjunction with an action to determine a liability (such as the simultaneous filing of an erroneous refund action when the five-year statute applies), the government may request a court to order the taxpayer to turn over to the court or to the IRS funds or property, and to account for any funds not turned over. This method was successfully used in United States v. Foster, 51 Fed. Appx. 915 (4th Cir. 2002), aff'g 89 AFTR2d 2002-1063 (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). The taxpayer in Foster received a $500,000 erroneous refund. The court found that she deposited part of the money in her checking account, transferred part to other persons, and purchased a $40,000 Mercedes automobile, even though she knew that the refund had been fraudulently obtained and that she was not entitled to any of the money.

Issue 4: Collection Action

Without establishing any reason at all for recovery, the IRS as the authorizer or issuer of a payment can take immediate action to prevent the payment of a liability or, if payment has already been made, to recover a refund 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 can cause (such as by issuing a voucher canceling the payment voucher) FMS to stop issuance of the EFT or check before it leaves the FMS facility. We have been advised by FMS that their processing time for a check is 10 days and their processing time for an EFT is three days, both measured from the date that FMS receives the electronic voucher from the IRS. If the payment is successfully stopped, FMS re-credits the amount back to the IRS.

Another way is to request a Mail Stop. If an erroneous refund is discovered after the refund check is put in the hands of USPS, the IRS can submit an expedited request 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, which states: “[a] federal agency may recall any mail-piece sent as official mail by submitting to any post office a Mailgram or an Express Mail letter identifying the piece.” The USPS treats the IRS as the sender of all IRS refund checks.

The USPS inputs the information into its computer system to notify processing and receiving postal facilities, which will conduct searches for the mail item. If the USPS is able to locate the mail item in its hands before delivery, the mail item will be returned to the IRS. The IRS processes a returned check as a voided check, the paper check is returned to FMS, and FMS re-credits the amount back 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 & Subs., 235 F.3d 11 (1^{st} 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 in the following ways. One way is to request 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.

Another way is to petition a court for issuance of a seizure warrant. If the refund or refund check is in the hands of the preparer or the taxpayer, and the Criminal Investigation Division is considering recommending prosecution of the person holding the refund or refund check, the Special Agent can refer a request for a seizure warrant for the check or the proceeds. The bases for issuance of the warrant are the facts establishing fraud and the violations that are being considered for prosecution or that support the forfeiture. This does not appear to be a likely approach in these cases.

Issue 5: Referral of the Return Preparer for Investigation

We agree with the analysis of this issue, and have no additional comments.

Please contact (202) 622-4940 if you have any further questions.

Attachment (1)

Attachment

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. section 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 requires 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 sections 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. In addition to the statutory requirements recited above, however, the courts have also generally required that the returns be filed by the taxpayer "in good faith". For example, in 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 falsely reported foreign earned income on the Form 2555 or Form 2555-EZ when they knowingly had no foreign earned income. 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. (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. A return may be inaccurate or even fraudulent and nevertheless be a valid return. See Badaracco v. Commissioner, 464 U.S. 386, 397 (1984).

Because the taxpayers in this case have failed to follow the form instructions when completing their returns, the IRS might be able to argue that these taxpayers did not make an honest and reasonable attempt to comply with the tax law. However, we do not believe it would be prudent to make such an argument in this case. Instead, we believe that the IRS should process the returns, and deny the claims for refund as part of a deficiency determination.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

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