OFFICE OF
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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE SERVICE CENTER ADVICE

MEMORANDUM FOR DISTRICT COUNSEL, PENNSYLVANIA DISTRICT
CC:NER:PEN:PHI

FROM: Assistant Chief Counsel (Field Service)
CC:DOM:FS:PROC

SUBJECT: INTEREST ABATEMENT RE: FUNDS EMBEZZLED FROM IRS LOCKBOX

This memorandum responds to your request for significant advice dated November 4, 1999, in connection with questions posed by the Office of the Treasury Inspector General for Tax Administration (TIGTA) through the Philadelphia Service Center.

ISSUES

1. Whether interest and penalties may be assessed against A for late payment of tax attributable, in part, to amounts paid into a lockbox used by the Service located in a bank that were embezzled by a bank employee, and, if so, in what amounts.

2. Whether interest and penalties may be assessed against A for late payment of tax attributable, in part, to amounts paid to the Service that were embezzled by a Service employee, and, if so, in what amounts.

3. Whether interest and penalties may be assessed against A for late payment of tax attributable, in part, to amounts paid to A's accountant for forwarding to the Service that were embezzled by A's accountant, and, if so, in what amounts.

4. Whether the suspension of collection notices to A during the pendency of a TIGTA investigation into the possible embezzlement of tax deposits to the Service affects the assessment of interest and penalties in the situations described below.

CONCLUSIONS

1. The Service should abate all interest and penalties attributable to the underpayment in tax caused by the embezzlement of A's estimated tax payment by the bank employee. A is responsible for any interest and penalties attributable to the late filing and payment of $400, as that liability is independent of, and would have occurred regardless of, the embezzlement.

2. The Service should abate all interest and penalties attributable to the underpayment in tax caused by the embezzlement of A's estimated tax payment by the Service's employee. A is responsible for any interest and penalties attributable to his late filing and payment of $400, as that liability is independent of, and would have occurred regardless of, the embezzlement.

3. Under the facts presented, no abatement of interest is warranted in this situation. Whether penalties should be asserted depends upon whether, based on all of the facts and circumstances of the case. In general, the misappropriation of funds by a taxpayer's agent does not excuse the taxpayer from the penalties under section 6651(a)(2) and section 6654.

4. The suspension of collection notices to A during the pendency of the TIGTA investigation of the embezzlement of tax deposits does not affect the assessment of interest and penalties in any of the three situations described above. No abatement of interest or penalties is warranted as a result of the suspension because A's return was not filed timely, because there was no written contact from the Service with respect to A's liability, and because the tax on which the interest and penalties were accruing had been reported on A's return.

FACTS

Issue 1

A makes timely quarterly estimated tax payments to the Internal Revenue Service. In September YR1, A mailed an estimated tax payment in the amount of $5,000 to a Service lockbox located in B Bank. The envelopes and vouchers supplied to A by the Service do not indicate that the payments are made to a lockbox. The payment is received at B Bank in a timely fashion, but is stolen by a B bank employee.

The Office of Treasury Inspector General for Tax Administration (TIGTA) investigates B Bank after receiving several allegations of the theft of Service lockbox funds. A's September 15th payment is not included in the allegations prompting the TIGTA investigation.

On April 15, YR2, A filed an extension of time in which to file his income tax return. A subsequently files his tax return on November 15, YR2, after the time for filing his tax return, as extended, had passed. The tax return reflects an unpaid tax liability of $400, with respect to which A encloses payment.

On November 30, YR2, TIGTA determines that A's September 15, YR1 payment was among the items stolen from the lockbox. TIGTA requests that the Service suspend all collection activity on A's YR1 account pending TIGTA's completion of its investigation. On February 1, YR3, TIGTA determines that B Bank's employee stole A's September 15, YR1 estimated tax payment. After the B Bank is notified of its employee's embezzlements, B Bank sends the Service funds to cover the employee's embezzlements, including $5000 representing the theft of A's September 15, YR1 payment.

Issue 2

The facts are the same as Issue 1, except that A's deposit was embezzled by a Service employee responsible for processing the payments made to the lockbox. After the Service employee is confronted with evidence of the embezzlement, the Service employee returns the embezzled funds to the Service.

Issue 3

The facts are the same as in Issue 1, except that A gave his accountant the funds to make his estimated tax payment, and the accountant misappropriated it. The funds are never deposited at the lockbox. After the accountant's misappropriation is discovered, however, the accountant makes a $5,000 payment on A's behalf and designates the payment to A's YR1 income taxes.

LAW AND ANALYSIS

I.R.C. § 6404(a) permits the Service to abate the unpaid portion of any tax assessment or liability. Interest and penalties relating to a tax assessment are those liabilities that would arise with respect to the tax assessment. I.R.C. § 6665(a)(2).

Among the assessments listed in section 6404(a) which the Service is permitted to abate are tax assessments or related liabilities which are erroneously or illegally assessed. I.R.C. § 6404(a)(3).

I.R.C. § 6302 authorizes the Service to use banks, trust companies, domestic building and loan associations, and credit unions that are depositories or financial agents of the government to receive any tax payments. Correspondingly, the

Service may contract with a bank for lockbox services as a place of payment. Wiemerslage v. United States, 838 F.2d 899 (7th Cir. 1988).

In all three scenarios for which advice has been sought, the assessment of tax is correct and is based on the amount reported by A on A's return. At issue, however, is the date the payment was received by the Service.

Issue 1

A did not receive credit for the embezzled third quarter estimated tax deposit until the bank sent a payment to the Service to cover its employee's embezzlements. As a result, interest and penalties accrued with respect to the apparent unpaid liability. Under the facts described in your memorandum, A should be credited for the estimated tax payment as of the due date of the return, without extensions. See I.R.C. § 6513(b)(2). There are two bases for this position, as described below.

First, there was an agency relationship between the Service and the bank. The Service was authorized to use the bank as a payment center for receiving taxes. I.R.C. § 6302(c).[1] The bank processed the lockbox payments and reported them to the Service. Further, the payment materials provided the public affirmatively led them to believe that their payments were going directly to the Service. Since the bank is an agent of the Service, the Service is responsible to A for placing A's payment in a situation in which the bank employee could embezzle the payment. See Restatement of Agency 2d, §§ 178, 261; cf., Hutzler v. Hertz Corporation, 39 N.Y.2d 209, 383 N.Y. Supp. 2d 266 (1976); Navrides v. Zurich Insurance Co., 97 Cal. Rptr. 309, 488 P.2d 637 (1971); Annotation, "Discharge of Debtor Who Makes Payment by Delivering Check Payable to Creditor to Latter's Agent, Where Agent Forges Creditor's Signature and Absconds with Proceeds", 49 ALR3d 843.

In addition to the agency arguments above, general contract principles would require the Service to credit A with a timely payment. The Service had set forth a

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[1]If the taxes paid by A had been corporation income or estimated taxes, taxes withheld on nonresident aliens and foreign corporations, employment, unemployment or railroad retirement taxes, or withholdings attributable to nonpayroll payments (such as pensions, annuities, and gambling winnings), the regulations promulgated under section 6302 could be cited as authority for attributing A with the payment at the time it was received by the depositary. See, for example, Treas. Reg. §1.6302-1(b) ("Amounts deposited under this section shall be considered as payment of the tax."); Treas. Reg. §1.6302-2(b)(5); Treas. Reg. § 31.6302-1(i)(6); cf., 31 C.F.R. § 203 et seq. Since the payment of estimated taxes by individuals is not a category specifically covered in the regulations under section 6302, however, section 6302(c) should not be directly relied upon as an authority for crediting A with a timely payment.

method in which it would accept payment from A by giving A payment materials directing how payment be made. The address provided was the bank lockbox (although it was not identified as a lockbox). A followed the Service's directions; therefore, when payment was received at the bank lockbox, A was entitled to credit for the payment. See generally 60 Am. Jur.2d 939, § 88; cf., Raymond v. Tyson, 58 U.S. 53 (1855).

When credited with a timely payment, A's underlying tax liability attributable to the shortfall in estimated tax payments caused by the embezzlement is eradicated. A's unpaid interest and the penalties attributable to that shortfall[2] should be abated as erroneously assessed. I.R.C. § 6404(a).

A is responsible for any interest and penalties attributable to his late filing and payment of $400, since that liability is independent of, and would have occurred regardless of, the embezzlement. Because there was a suspension of collection notices to A during the pendency of the TIGTA investigation into the possible embezzlement of tax deposits to the Service, A might contend that the Service unnecessarily caused the amount of his interest and penalty to accrue. I.R.C. § 6404(e) authorizes the Internal Revenue Service to abate interest attributable to unreasonable errors or delays performed by its officers or employees, acting in an official capacity, in the performance of ministerial or managerial acts.[3] Section 6404 (e)(1), however, requires that the error or delay occur after the taxpayer was contacted in writing with respect to the deficiency or payment, and that no significant aspect of the error or delay be attributed to the taxpayer. In this case, both the embezzlement of A's payment and the decision not to notify A of his outstanding tax liability, which had been caused by the embezzlement, occurred before any written contact from the Service with respect to the payment was made; thus, the provisions of section 6404(e) are inapplicable.[4]

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[2]We note that estimated tax penalties under I.R.C. § 6654 would presumably have been assessed against A for the period from September 15, YR1 to April 15, YR2. That penalty is assessed in lieu of interest and the failure to pay penalty under section 6651(a)(2). See I.R.C. § 6651(e). Of course, interest and failure to pay penalties would have then accrued on A's outstanding liabilities after the due date of the return.

[3]The authority to abate interest for managerial acts applies to tax years beginning after July 30, 1996.

[4]Section 6404(g) authorizes the Service to suspend interest and certain penalties if it fails to provide notice to the taxpayer specifically stating the taxpayer's liability and the basis for the liability. Section 6404(g) applies to taxable years ending after July 27, 1998. However, that provision does not apply unless the taxpayer files a timely return and the Service's failure to contact the taxpayer is more than eighteen months after the

Issue 2

Once it is established that a Service employee received A's estimated tax payment and then misappropriated the funds, A should be given credit for the deposit as of the due date of the return, without extension. See I.R.C. § 6513(b)(2). We have assumed that the Service employee had access to A's payment in the course of the Service employee's employment. In such a case, an agency relationship between the Service and the Service employee clearly exists, which would attribute receipt of the payment to the Service. See Restatement of Agency 2d, §§ 178, 261. In addition, as in Issue 1, since A made its payment in accordance with the instructions provided by the Service, A should be credited for the payment, irrespective of the Service employee's embezzlement. When credit is given for the payment, A's underlying tax liability attributable to the shortfall in estimated tax payment caused by the embezzlement is eradicated. The unpaid interest and penalties attributable to that shortfall should be abated as erroneously assessed. I.R.C. § 6404(a).

A is responsible for any interest and penalties attributable to his late filing and payment of $400, as that liability is independent of, and would have occurred regardless of, the embezzlement. The provision of section 6404(e) is inapplicable in this scenario for the same reasons set forth in Issue 1 above.

Issue 3

There is also an agency relationship present in this scenario, but in this case the relationship is between A and A's accountant. A is responsible for the timely payment of its estimated tax, and A may not generally delegate responsibility to his agent for the payment to avoid accountability for the failure of the payment to properly reach the Service. No abatement of any interest is warranted in this situation because none of the provisions of I.R.C. § 6404 providing for abatement of interest are applicable. Similarly, we do not believe that the failure to pay estimated tax penalty (which would run from September 15, YR1 to April 15, YR2, the due date of the return) should be abated, as that penalty, in effect, is assessed in lieu of interest for the pre-return filing period. The reasonable cause exceptions under I.R.C. § 6654 are very limited and are not applicable under the facts presented. See I.R.C. § 6654(e). If a penalty was assessed under I.R.C. §

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later of the date on which the return is filed or the due date of the return without regard to extensions. Further, section 6404(g)(2)(C) excludes from eligibility for abatement interest that relates to any tax liability reported on the taxpayer's return. In this case, since A filed his return delinquently and since the tax on which the interest and penalties were accruing had been reported on A's return, section 6404(g) is not applicable.

6651(a)(2) for the period after the due date of the return, the Service has also generally taken the position that a misappropriation of the taxpayer's funds by an agent would not excuse the taxpayer from payment of a penalty under section 6651(a)(2). See, Conklin Brothers of Santa Rosa, Inc. v. United States, 986 F.2d 315 (9th Cir. 1993); Perugino v. United States, 85-1 USTC ¶ 9215 (M.D. Pa. 1985); Thom v. United States, 80-2 USTC ¶ 9814 (D. Ore. 1980); but see In re Matter of American Biomaterials Corporation, 954 F.2d 919 (3rd Cir. 1992). This position comports with the Supreme Court's bright-line rule in Boyle v. United States, 469 U.S. 241, 252 (1985), that "failure to make a timely filing of a tax return is not excused by the taxpayer's reliance on an agent, and such reliance is not 'reasonable cause' for late filing under section 6651(a)(1)."

Issue 4

As discussed on pages 5 and 6 above, the suspension of collection notices to A during the pendency of the TIGTA investigation does not affect the assessment of interest and penalties. No abatement is warranted as a result of the suspension. I.R.C. § 6404(g) is not applicable because 1) A's return was not filed timely, 2) there was no written contact from the Service with respect to A's liability, and 3) the tax on which the interest and penalties were accruing had been reported on A's return.

If you have any further questions, please call.