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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
August 28, 2002

CC:PA:APJP:2
SCAF-129429-02

Number: **200242036**
Release Date: 10/18/2002
UILC: 6011.00-00; 6201.00-00;
6702.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE
SIGNIFICANT SERVICE CENTER ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL - SALT LAKE CITY (SMALL BUSINESS/SELF-EMPLOYED)
CC:SB:5:SLC

FROM: Ashton P. Trice
Senior Technician Reviewer, CC:PA:APJP:2

SUBJECT: Form 1041 and Application of Internal Revenue Code (I.R.C.) Section 6702

This Service Center Advice responds to your memorandum dated June 4, 2002. In accordance with I.R.C. § 6110(k)(3), this Service Center Advice should not be cited as precedent.

ISSUES

1. Whether Forms 1041, by which purported trusts claim refunds in the amount of social security taxes paid by the trust's fiduciary, are valid returns under I.R.C. § 6011?

2. Whether Forms 1041, by which purported trusts claim refunds in the amount of social security taxes paid by the trust's fiduciary, are subject to the frivolous return penalty under I.R.C. § 6702?

3. What assessment and collection procedures should the Service use to recover erroneous refunds based on Forms 1041 that claim refunds in the amount of social security taxes withheld from the purported fiduciary's lifetime earnings?

CONCLUSIONS

1. The Service should treat these Forms 1041 as valid returns under I.R.C. § 6011, unless entries on the returns or attached correspondence negate the intent to file.

2. The Service may assess the frivolous return penalty under I.R.C. § 6702 against individuals who file Forms 1041, claiming refunds in the amount of social security taxes paid, if the Service determines that the trusts are shams.

3. Section 6201(a)(3) authorizes the Service to summarily assess the erroneously refunded or credited amount of income tax withholdings claimed on the Form 1041. Once assessed, the Service may avail itself of all of the administrative and judicial collection remedies available under the Code to recover an erroneous refund.

FACTS

Some individuals file Forms 1041, titled "U.S. Income Tax Return for Estates and Trusts," claiming a refund of all social security taxes paid during their lifetimes. The promoters of this scheme instruct individuals to request a "lifetime earnings statement" from the Social Security Administration and to request an employer identification number (EIN) from the Service as a basis for preparing the claim. The promoter prepares a Form 1041 based on the lifetime earnings statement and the EIN and charges the individual a preparation fee.

The individual's name followed by the word "trust" is listed as the name of the trust (taxpayer) on the Form 1041. The individual filing the claim is listed as fiduciary of the trust. The amount of the individual's lifetime earnings subject to social security tax is listed on the Form 1041 on the line titled "Total Income." The trust then takes a deduction equal to the amount reported as total income on the line titled, "Fiduciary fees." After a deduction for "exemptions," the Form 1041 reports negative taxable income and zero tax liability. The trust then reports the lifetime social security tax withholding as "Federal income tax withheld" on line 24e of the Form 1041. Since the Form 1041 shows no tax liability, the trust requests a refund for the amount equal to the individual's (fiduciary's) lifetime social security withholdings. Generally, the individual signs the Form 1041 as the fiduciary (trustee of the "trust")

LAW AND ANALYSIS

1. Handling of Forms 1041

a. Validity of Forms 1041

The courts have extensively interpreted the I.R.C. § 6011 return requirement. Under that precedent, we think that the Service should treat these Forms 1041 as valid returns triggering the statute of limitations on assessment. In *Zellerbach Paper Co. v. Helvering*, 293 U.S. 172, 180 (1934), the Supreme Court stated that "[p]erfect accuracy or completeness is not necessary to rescue a return from nullity, if it purports to be a return, is sworn to as such, and evinces an honest and genuine endeavor to satisfy the law." *See also Badaracco v. Commissioner*, 464 U.S. 386 (1984); *Florsheim Bros. Drygoods Co. v. United States*, 280 U.S. 453 (1930). The lower courts have subsequently synthesized the criteria enunciated by the Supreme Court into the following four-part test for determining whether a defective or incomplete document is a valid return: "First, there must be sufficient data to calculate tax liability; second, the document must purport to be a return; third, there must be an honest and reasonable attempt to satisfy the requirements of the tax law; and fourth, 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). This generally accepted formulation of the criteria for determining a valid return is known as the "substantial compliance" standard. If a defective or incomplete document meets the "substantial compliance" standard, the document is a valid return for purposes of the statute of limitations on assessment and for purposes of determining whether the failure to file penalty of I.R.C. § 6651(a) applies.

Apart from the so-called "tax protester" cases, there is little authority for determining what constitutes an honest and reasonable attempt to satisfy the requirements of the tax law. *See, e.g., United States v. Smith,* 618 F.2d 280 (5th Cir. 1980) (zeros and constitutional objections); *United States v. Moore, 627 F.2d 830 (7th Cir. 1980); United States v. Porth, 426 F.2d 519 (10th Cir. 1970); Beard, supra; Thompson v. Commissioner, 78 T.C. 558 (1982); and Sochia v. Commissioner, T.C. Memo. 1998-294.* Courts, however, have been reluctant to declare defective or incomplete returns as nullities in the absence of protester language or other statements negating the intent to file. Cases such as *Badaracco*, *Steines v. Commissioner*, T.C. Memo. 1991-588 (frivolous Schedule C claiming $100 billion loss), and *Nicolaisen v. Commissioner,* T.C. Memo. 1985-120, are typical. In *Badaracco*, the taxpayer filed returns that were fraudulent, but which contained no tax protester arguments or alterations to the official return form. Despite the fraudulent nature of the returns, the Supreme Court declared them valid for purposes of starting the statute of limitations, noting that "[a]lthough those returns, in fact, were not honest, the holding in *Zellerbach* does not render them nullities." *Badaracco* 464 U.S. at 397. Therefore, despite the fact that a return may erroneously, fraudulently, or frivolously claim a refund for the taxpayer's lifetime social security tax withholdings, it is considered a valid return for purposes of starting the statute of limitations on assessment.

Under the circumstances, we think that a reviewing court would conclude that the Forms 1041 are valid returns under I.R.C. § 6011 and the judicial substantial compliance standard. The documents do not contain overt Constitutional objections to the income tax and are not otherwise characterized by traditional "tax protester" arguments. Individuals filing these fraudulent returns/claims apparently do not make statements negating the intent to file. (See "Processing of Forms 1041," below.) We therefore recommend that the Service treat the Forms 1041 as returns within the meaning of I.R.C. § 6011.

b. Processing of Forms 1041

We suggest that the Service take appropriate steps to adjust the accounts of the affected taxpayers, whether or not the Service has erroneously issued the requested refunds.

In each case where the Service has not issued a refund, the Service presumably entered the appropriate freeze code on the taxpayer's account to ensure that the claimed overpayment was not refunded. We recommend that the Service reverse the

reported prepayment credits (withholding) on the account. This action would bring the taxpayer's account into balance since the reported tax liability on the return was zero and the prepayment credits, after the reversal, are zero. Also, as noted above, the filing of an original return reflecting an overpayment constitutes a claim for refund. Until the Service disallows the claim, the limitations period for filing suit in district court or claims court remains open. Therefore, we recommend that the Service issue a formal notice of claim disallowance, as provided by I.R.C. § 6532(a)(1), to start the limitations period running. Once the notice of claim disallowance is issued, the taxpayer has two years to challenge the claim disallowance in court.

Occasionally, entries on a return or attached statements or correspondence might be inconsistent with one of the four factors of the substantial compliance standard cited in *Beard*. For example, in *Williams v. Commissioner*, 114 T.C. 136 (2000), the Tax Court found that an attached disclaimer negated the jurat and that the substantial compliance standard was not met. If a Service employee finds correspondence or attachments included with returns that could affect whether a Form 1041 is a valid return, the employee should seek legal advice.

2. Frivolous Return Penalties

Prior to the enactment of section 6702, Congress was concerned with the rapid growth in deliberate defiance of the tax laws by tax protesters; the Service had 13,600 protester returns under examination as of June 30, 1981. Congress recognized that many of those protesters were induced to file protester returns through the criminal conduct of others. Congress also recognized that promoters and advisors frequently emphasized the lack of any penalty when sufficient tax had been withheld from wages and encouraged others to play the "audit lottery." Section 6702 was enacted because Congress believed that an immediately assessable penalty on the filing of protester returns would help deter the filing of such returns, and would demonstrate the Government's determination to maintain the integrity of the income tax system.

Section 6702 imposes an immediately assessable penalty of $500 on any individual who files a document which purports to be a return of income tax if (1) the document fails to contain information from which the substantial correctness of the amount of tax shown on the return can be judged or contains information that on its face indicates that the amount of tax shown on the return is substantially incorrect, and (2) such conduct arises from a position which is frivolous, or from a desire (which appears on the face of the purported return), to delay or impede administration of the Federal income tax laws.

a. Individual

In order to assess the frivolous return penalty under section 6702, an individual must file the document in question. The returns in question purport to be returns filed by trusts, not individuals. Section 6702 does not apply to returns that trusts file, even if

those returns are clearly frivolous. Accordingly, the Service should not assert the section 6702 penalty unless the trust is a sham. If the trust is a sham, the Service should disregard it and treat the return as if filed by an individual. While the information on the face of a Form 1041 may make one question the validity of the trust, that information alone does not establish that the trust is a sham. Even a valid trust can file a frivolous return. Therefore, we believe that the Service should investigate the trusts listed on the Forms 1041 and establish that they are in fact shams that are disregarded for federal tax purposes before assessing a frivolous return penalty against the individual using the sham.[1]

b. Purports to be a Return of Tax Imposed by Subtitle A

Another requirement for proper assessment of the section 6702 penalty is that the individual file "what purports to be a return of tax imposed by subtitle A." Under the facts related, the document being filed is a Form 1041, "U.S. Income Tax Return for Estates and Trusts." Income taxes on Estates and Trusts are imposed by Subtitle A of the Code. *See* I.R.C. § 641 *et seq*. Furthermore, line 24e of the Form 1041 claims that federal income tax has been withheld and the amount withheld is the amount that should be refunded in full. Thus, we conclude that the Forms 1041 being filed are what purport to be returns of tax imposed by subtitle A. I.R.C. § 6702(a)(1).

We recognize that the underlying rationale for the filing of the Form 1041 may be that individuals are seeking to recover social security taxes that have been withheld from their lifetime earnings. Furthermore, social security taxes are not taxes imposed by subtitle A; they are imposed by subtitle C. Thus, one might argue that section 6702 does not apply because the Forms 1041 in question are actually claims for refund of social security taxes, and not returns of tax imposed by subtitle A. Such an argument, however, ignores the fact that nothing filed with the Forms 1041 states the underlying rationale on which individuals file the returns. The documents as filed clearly purport to be income tax returns. Under I.R.C. § 6702(a)(1), purported returns are subject to the frivolous return penalty. *See Holker v. United States*, 737 F.2d 751 (8th Cir. 1984).

c. Contains Information That on its Face Indicates the Self-assessment Is Substantially Incorrect

It is our understanding that the Forms 1041 contain information that facially indicates that the self-assessments are substantially incorrect. These returns list the amount of

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[1] We have found no case in which a trust was treated as a sham for purposes of assessing a penalty under section 6702. We believe, however, that the analysis of what constitutes a sham trust for purposes of determining a deficiency against an individual would be equally applicable with respect to determining when it is appropriate to assess the section 6702 penalty against an individual filing an income tax return purported trust.

the taxpayers' lifetime earnings subject to social security taxes as the "total income." Typically, the returns fail to identify the source or type of income that constitutes the "total income," although the return requests this information. The return then claims there were "fiduciary fees" in the exact amount as the total income. After claiming deductions for exemptions, reporting a negative taxable income and zero tax liability, the taxpayers report the amount of lifetime social security tax withholdings as income tax withholdings on the returns and claim refunds for that amount. Such a combination of line item entries and highly unlikely amounts "indicates that the self-assessment is substantially incorrect" for purposes of section 6702.

d. Frivolous Position

Section 6702 also requires that the taxpayer's position for providing the substantially incorrect information on the return be due to a frivolous position or a desire (which appears on the face of the return) to impede tax administration. I.R.C. § 6702(a)(2). We believe that it is patently frivolous to contend that total income represents fiduciary fees. Furthermore, the substance of the taxpayers' refund claims are an attempt by individual taxpayers to obtain refunds of their personal, lifetime, social security tax withholdings, using the vehicle of a Form 1041 Trust Return. The Internal Revenue Code provides for no such procedure and contains no statutory authority for obtaining a refund of taxpayer's personal lifetime social security tax withholdings. Accordingly, we conclude that this element of the frivolous return penalty is satisfied.

As discussed in section "2a. Individual", above, if the Service determines that the purported trust is a sham, we believe that the frivolous return penalty may be asserted against the individual standing behind the sham trust that files the Form 1041.

3. Post-assessment collection, including erroneous refund suits

It is our understanding that the taxpayers report their lifetime social security tax withholdings on line 24e titled, "Federal income tax withheld." Based on this reporting position, we will examine whether section 6201(a)(3) provides authority for the Service to make a summary assessment. Section 6201(a)(3) provides the Service with the authority to make an assessment "[i]f 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." To the extent that the forms at issue claim an amount that equals the total social security tax withheld on line 24e of the Form 1041 as Federal income tax withheld, which constitutes an income tax withheld at the source, then the amount is properly subject to the summary assessment process provided for by I.R.C. § 6201(a)(3). Given that conclusion we see no need to address the applicability of notice of deficiency procedures.

Once assessed, the liability may be collected in the same manner as a tax within the ten-year collection statute. The Service may avail itself of all of the administrative (*i.e.*, levy) and judicial (*i.e.*, lien foreclosure suit, erroneous refund suit) collection remedies

available under the Code. The Service must ensure, however, that proper statutory and administrative procedures are followed and that the trusts are advised of their rights and provided with all of the required notices.

One possible remedy for administratively recovering the erroneous refunds issued as a result of the fraudulent Forms 1041 would be jeopardy levy. The general requirements set forth in sections 6330 and 6331 do not apply if the Service finds that collection of the tax is in jeopardy. I.R.C. §§ 6330(f)(1) and 6331(a). Instead, the Service can issue a notice and demand for immediate payment and can immediately levy upon the taxpayer's property.

In order for the Service to make a finding that collection of the tax is in jeopardy, the Service must show that: (1) the taxpayer is or appears to be designing quickly to depart from the United States; (2) the taxpayer is or appears to be designing quickly to place his, her, or its property beyond the reach of the government either by removing it from the United States, by concealing it, by dissipating it, or by transferring it to other persons; (3) the taxpayer is in danger of becoming insolvent. *Henderson v. United States*, 949 F. Supp. 473 (N.D. Tex. 1996).[2] The Service would not be able to make a jeopardy levy merely on the basis that the refund was paid as a result of a fraudulent claim, or that the fraudulent scheme was being promoted by a third-party individual. Rather, the Service would need to conduct some initial investigation to determine first whether the trusts are legitimate, and second which, if any, of the jeopardy criteria exist. Even if the trusts at issue are legitimate, jeopardy may exist if they are transferring or dissipating assets.[3] More than likely, these trusts are being set up for the sole purpose of receiving the refunds, and the refunds are being transferred to other parties, such as the trustee or the trustee's family. If that is true, then the Service could make a determination that collection is in jeopardy because the trust is transferring its assets to third parties or is in danger of becoming insolvent. The determination that collection of tax is in jeopardy must be made on a case-by-case basis, and the Service cannot assume that what is happening with one of these trusts is true with respect to all.

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[2] Generally, a bankruptcy or a receivership proceeding, alone, is not sufficient to warrant a jeopardy levy. While evidence of an imminent or actual bankruptcy may be one of the factors in determining whether the taxpayer's financial solvency is or appears to be imperiled, courts generally require more. See, *e.g.*, *Golden ADA v. United States*, 934 F. Supp. 341 (N.D. Ca. 1996); *Cousins v. United States*, 87-2 U.S.T.C. 9456 (N.D. Fla. 1987). Given this case law, it is our view that bankruptcy or receivership, without more, does not establish financial insolvency for jeopardy purposes.

[3] If the trusts are shams, that may support making assessments against the individual owners of the trusts, filing nominee liens, and levying on trust assets. However, this would not necessarily support a jeopardy levy against the individual trust owner's property unless the trust is part of a scheme to dissipate the assets of the individual owner of the trust.

Assuming that the Service can satisfy the requirements for making a determination that collection is in jeopardy, certain procedures must be followed. These procedures are required by the Code and the Internal Revenue Manual. First, the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA), section 3434 amended I.R.C. § 7429(a) to require that the Chief Counsel or his delegate personally approve, in writing, all jeopardy and termination assessments and jeopardy levies prior to the assessment or levy. Therefore, the appropriate Counsel official must give prior approval to jeopardy levy. Second, section 7329(a)(1)(B) provides that within five days of making the jeopardy levy, the Service must provide the taxpayer with a written statement of the information upon which the Service relied in making the jeopardy levy. This means that the written statement must specifically describe which of the jeopardy criteria mentioned above the Service relied on. Neither the Code nor the regulations prescribe how the written statement is to be sent, *i.e.*, by certified or regular mail or by personal delivery. However, IRM 5.11, *Notice of Levy Handbook*, section 3.5(5) instructs Service personnel to try to give Pattern Letter 2439(P) to the taxpayer in person, and if personal delivery is not practical, to send it to the taxpayer's last known address by certified mail. Pattern Letter 2439(P) contains all of the information that the taxpayer is entitled to, including the reason for making the jeopardy levy, a description of the taxpayer's rights to administrative and judicial review under section 7429, and notice of the taxpayer's right to administrative and judicial review under section 6330. If the Service determines that a jeopardy levy is not appropriate in all, or some of these cases, the Service may initiate erroneous refund suits against the trusts, or its nominees, under I.R.C. § 7405.

Regardless of what other remedies are available to the Service to recover an erroneous refund, the Service may always file an erroneous refund suit pursuant to I.R.C. § 7405.[4] Section 6532(b) sets forth the applicable period of limitations. The section provides in relevant part as follows:

> [A] suit [under section 7405] may be brought at any time within 5 years from the making of the refund if it appears that any part of the refund was induced by fraud or misrepresentation of a material fact.

I.R.C. § 6532(b). The five-year limitations period begins to run from the date the taxpayer receives the erroneous refund. *O'Gilvie v. United States*, 519 U.S. 79 (1996).

The Government bears the burden of proof on all of the elements of the erroneous refund. *Soltermann v. United States*, 272 F.2d 387 (9th Cir. 1959); *United States v. Moreno,* 80-2 U.S.T.C. ¶ 9536 (S.D. Fla. 1980). Thus, the Service has the burden of

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[4] Interest on an erroneous refund accrues at the underpayment rate from the date of the payment of the refund. I.R.C. § 6602. The section 6404 abatement provision is not applicable here, because the erroneous refunds at issue were caused by the taxpayer (trust) or a related party (trustee). I.R.C. § 6404(e)(2).

showing that the refund was erroneous and the amount of the refund. If the taxpayer raises the statute of limitations as a defense, the Service will also have to show that the applicable statute of limitations has not expired.

Neither section 6532(b) or section 7405, nor the regulations thereunder, define the term "fraud" or "misrepresentation of a material fact." *See* Treas. Reg. § 301.6532-3. Webster's Third New International Dictionary, however, defines fraud as "an intentional misrepresentation, concealment or nondisclosure for the purpose of inducing another ... to part with some valuable thing; a false representation of a matter of fact by words or conduct." Webster's Third New International Dictionary (Third Edition 1986). Hence, in order to show that an erroneous refund was "induced by fraud," the Service will have to show that the taxpayer made false representations, concealed information or failed to disclose important facts, with the intent of obtaining funds to which he or she was not entitled.

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