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

OFFICE OF
CHIEF COUNSEL

Number: **199919031**
Release Date: 5/14/1999

CC:EL:GL:Br2
CT-104674-99

March 17, 1999

UILN: 9999.98-00

MEMORANDUM FOR ASSISTANT REGIONAL COUNSEL (GENERAL LITIGATION)
SOUTHEAST REGION

FROM: Gary D. Gray
Assistant Chief Counsel (General Litigation)

SUBJECT: South Carolina Fraudulent Scheme: Fraudulent Forms [redacted]

This Chief Counsel Advice addresses a number of legal issues raised and discussed in a meeting held on March 4, 1999, to assist the Internal Revenue Service ("Service") in recovering several erroneous refunds issued as a result of a refund scheme involving the filing of fraudulent Forms [redacted]. This document is not to be cited as precedent.

ISSUES:

1. Can the Service assess the amount refunded pursuant to I.R.C. § 6201(a)(3)?

2. What must the Service do to effectuate an assessment under I.R.C. § 6201(a)(3)?

3. What collection remedies are available to the Service to collect the tax once an assessment under I.R.C. § 6201(a)(3) is made?

4. Can the Service file an erroneous refund suit under I.R.C. § 7405 to recover the amounts erroneously refunded?

CONCLUSIONS:

1. To the extent the taxpayer overstated on Form [redacted] the amount withheld at the source or paid as an estimated income tax, the amount so overstated may be summarily assessed pursuant to I.R.C. § 6201(a)(3).

2. To effectuate an assessment under I.R.C. § 6201(a)(3), the assessment must comply with the requirements set forth in Treas. Reg. § 301.6203-1.

3. Once a valid assessment is made, the Service may use all available collection tools, including filing a Notice of Federal Tax Lien, issuing a levy, or seizing the taxpayer's or the taxpayer's nominee's assets, to collect the unpaid tax liability. The decision how best to facilitate collection should be made on a case-by-case basis.

4. The Service may file an erroneous refund suit to recover any funds erroneously refunded as a result of the fraudulent claim for a refund. The applicable statute of limitations is the five-year period set forth in I.R.C. § 6532(b).

BACKGROUND:

The nature of the fraudulent scheme

Based on the facts provided to us, it appears that a number of individuals in the North-South Carolina District were erroneously led to believe that they could obtain a refund of [redacted].[1] The proponents of this fraudulent refund scheme apparently instructed the individuals willing to participate in the scheme to do the following. [redacted].[2]

The Forms [redacted]

The figures used to complete each Form [redacted]. As completed, however, the Forms [redacted]. The purpose of the Form [redacted]

[1] To date, the Service has identified over 1,000 of these fraudulent Forms [redacted] claiming over $97,000,000 in refunds.

[2] In at least one case the application for the [redacted] was mailed simultaneously with the fraudulent Form [redacted].

[redacted]. As such, the figures used to complete the returns in question are fraudulent and not what they purport to be.

The returns filed are practically identical in content, except for the amounts reported and claimed and the amount of refund sought. [redacted].[3] The returns generally show a loss and, thus, no tax due. They also claim a refund [redacted]. The following illustrates how the returns were prepared and filed.

[redacted].[4]

[redacted][5]

The Service has identified over 1,000 of these fraudulent claims for refunds. We understand that the majority of these claims are frozen pending the completion of an investigation. Unfortunately, several (at least 40) refunds were issued as a result of these fraudulent claims. These refunds are erroneous and the Service has a legal right to recover them. They range from less than a $[redacted] to over $[redacted]. We understand that while a few individuals have returned the funds to the Service voluntarily, others are not willing to cooperate.

---

[3] Because the majority of the individuals who participated in this scheme filed a version of the Form [redacted] with the Service, all references are to items as they appear on the face of the Form [redacted] for the year.

[4] Although not reflected on the Form [redacted].

[5] Although not reflected on the Form [redacted].

LAW AND ANALYSIS:

Assessment under I.R.C. § 6201

To the extent a taxpayer, on a return or a claim for refund of income taxes, overstates the amount of "income tax withheld at the source, or 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 in the same manner as in the case of a mathematical or clerical error appearing upon the return. I.R.C. § 6201(a)(3). The deficiency procedures are not applicable to section 6201(a)(3) assessments. I.R.C. § 6211(a) and (b)(1). See, e.g., Hutchinson v. United States, 677 F.2d 1322, 1326 (9th Cir. 1982). Likewise, the math error procedures which require that the assessment be abated if protested by the taxpayer also do not apply. I.R.C. § 6201(a)(3). The Service may summarily assess the overstated amount and bill the taxpayer for the amount so assessed without a protest or a notice of deficiency.

The applicability of section 6201(a)(3) depends upon the filing of a "return or a claim for refund" which overstated the income tax prepayment credits. The question which needs to be answered is whether the Forms [redacted] filed with the Service in the instant situation constitute returns or a claims for refund within the meaning of the Internal Revenue Code.

The Service has determined that the Forms [redacted] in question are materially false. The [redacted] filing these documents had no income and no withholdings. The documents overstated the withholdings ([redacted]) for the sole purpose of fraudulently obtaining a refund. Thus, they are claims for refund. Moreover, the fact that a document filed with the Service may be materially false and fraudulent does not foreclose a legal finding that the document is also a return within the meaning of the Code. It is our understanding that the Office of the Assistant Chief Counsel (Income Tax & Accounting) has determined that the Forms [redacted] at issue here are returns, and, as such, must be treated as returns under the Internal Revenue Code. Furthermore, it has been determined that the amount of federal income tax withheld reported on these claims for refund or returns is overstated. See I.R.C. § 31(a)(1) ("The amount withheld

as tax under Chapter 24 shall be allowed to the recipient of the income as a credit against the tax imposed by this subtitle"). Thus, to the extent this overstated amount (here the entire amount claimed) was refunded to the [redacted], the amount may be summarily assessed against the [redacted] under I.R.C. § 6201(a)(3).[6]

The Service may not, however, assess any overpayment interest which it may have erroneously allowed on the fraudulent refund. See I.R.C. § 6611(b)(3). While underpayment interest under section 6601 is a tax imposed on the taxpayer which can be assessed under I.R.C. § 6201, overpayment interest authorized under section 6611 is by its very nature not a tax imposed on the taxpayer but a liability owed to the taxpayer by the Service. There is no statutory authority for assessing the amount of money erroneously paid to the taxpayer as overpayment interest. This amount, however, may be recovered as an erroneous refund pursuant to I.R.C. § 7405. See United States v. Steel Furniture, 74 F.2d 744 (6th Cir. 1935).

To be valid, the assessment of the overstated withholding credits refunded to the [redacted] must comply with the requirements of section 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). A transaction shown on the taxpayer's account as a reversal of income tax prepayment credits is not by itself a section 6201(a)(3) assessment. The assessed liability must be included on a Summary Record of Assessment (a Form 23C or RACS 006), the Summary Record of Assessment must be signed by an assessment officer, and the date of assessment is the date the assessment officer signs the Summary Record of Assessment. Treas. Reg. § 301.6203-1. Once the assessment of the overstated amount is made, notice and demand for this amount should be issued to the [redacted] pursuant to I.R.C. § 6303(a).

---

[6] Please note that where the alleged overpayment has not been refunded to the [redacted], the Service need not assess that amount under I.R.C. § 6201(a)(3), but may simply reverse the credits. See H.R. Rep. 1337, 83rd Cong., 2d Sess. A404 (1954); S. Rep. 1622, 83rd Cong., 2d Sess. 572 (1954). A credit is allowable under section 31(a)(1) only if it has been withheld from wages. Under the facts present here, it is known that the [redacted] had no income and no withholdings. The Service is not legally obligated to give the taxpayer credit for the amount claimed or to refund that amount to the taxpayer. The [redacted] assertion of the credit resulting in a claimed overpayment is, nevertheless, a claim for refund. The refund denial procedures, therefore, are appropriate to advise the [redacted] of the denial of the credit and the claim for refund, and to provide the [redacted] rights to contest the determination of the Service in a refund forum. An official notice of claim disallowance that meets the requirements of I.R.C. § 6532(a)(1) also triggers the running of a 2-year limitations period, after which the taxpayer may no longer sue for or obtain a refund, thus, providing finality.

Collection Once Assessment is Made

Once assessed, the liability resulting from the overstated withholding or income tax prepayment credits 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 both statutory and administrative procedures are followed and that the [redacted] are advised of its 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 [redacted] would be a 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 notice and demand for immediate payment may be made and the Service 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; or (3) the taxpayer is in danger of becoming insolvent. Henderson v. United States, 949 F. Supp. 473 (N.D. Tex. 1996).[7] 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

[7] 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.

whether the [redacted] are legitimate, and second which, if any, of the jeopardy criteria exist. Even if the [redacted] at issue are legitimate, jeopardy may exist if they are transferring or dissipating assets.[8] More than likely, these [redacted] are being set up for the sole purpose of receiving the refunds, and the refunds are being transferred to other parties, such as the [redacted] or the [redacted]. If that is true, then the Service could make a determination that collection is in jeopardy because the [redacted] 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 can not assume that what is happening with one of these [redacted] is true with respect to all.

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. This authority has been delegated by the Chief Counsel to Regional Counsel and to the Associate Chief Counsel (International) with the authority to redelegate. Therefore, the appropriate Counsel official must give prior approval to the jeopardy levy. Second, section 7429(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 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, the taxpayer's rights to administrative and judicial review under section 7429, and the taxpayer's right to administrative and judicial review under section 6330, which was enacted as part of RRA.

If the Service determines that a jeopardy levy is not appropriate in all, or some of the these cases, the Service may initiate erroneous refund suits against the [redacted], or its nominees, under I.R.C. § 7405.

---

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

Erroneous Refund Suit

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.[9] 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 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.

The Government's burden of proof with respect to the "misrepresentation of a material fact" is somewhat lower than in cases of "fraud." Webster's Third New International Dictionary defines "misrepresentation" as "an untrue, incorrect, or misleading representation." Webster's Third New International Dictionary (Third Edition 1986). The representation can be in a form of a statement, assertion, or a failure to disclose relevant information. The misrepresentation, however, must be regarding a fact that is

---

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

material or essential to the Service's decision to issue the erroneous refund. See, e.g., United States v. Indianapolis Athletic Club, Inc., 785 F. Supp. 1336 (S.D. Ind. 1991).

While a determination whether a refund or any part thereof was "induced by fraud or misrepresentation of a material fact" must be made on a case-by-case basis, the Service should be able to sustain its burden of proof in the present situation. But for the fraudulent claims filed by the [redacted], the Service would not have issued the erroneous refunds.

Other considerations

It has come to our attention that in at least one recent case the Service processed a claimed refund but was able to identify the refund as erroneous before the Department of the Treasury issued a refund check to the [redacted]. When this occurs, the refund check can be stopped with CC "NOREF" command code. [redacted]

If we can be of further assistance in this matter, please do not hesitate to contact us.

cc: Associate Chief Counsel (EL)
Deputy Assistant Chief Counsel (Income Tax & Accounting)
Assistant Chief Counsel (Criminal Tax)
North-South Carolina District Counsel
Chief, Branch 3 (General Litigation)
Director of Investigations (Tax Refund Fraud)
Deputy Director (National Operations Division)
National Director (Submissions Processing)
Program Analyst, Questionable Refund Program
Program Analyst, Customer Service, Business Master File (via fax)
Program Analyst, Submissions Processing, Business Master File (via fax)