OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL,

FROM: Chief, Branch 2
CC:EBEO

SUBJECT: Request for Field Service Advice

This Field Service Advice responds to your memorandum dated January 13, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

S Corporation =

ISSUES:

1. Whether the Receiver of S Corporation has standing to file a refund claim for income tax withheld, and FICA tax withheld and paid, with respect to the unreasonable portion of the salary paid to Shareholder.

2. Whether the Receiver's actions satisfy S Corporation's duty to first adjust overpaid employee FICA tax before filing a refund claim for its portion of the FICA tax.

3. Whether income tax withheld by S Corporation in prior years from wage payments to Shareholder may be refunded to S Corporation regardless of whether or not Receiver has standing to file a refund claim.

CONCLUSIONS:

1. The Receiver lacks standing to file a refund claim with respect to income tax withheld from payments to Shareholder because S Corporation's income and deduction items flow through to the Shareholder and thus the resulting tax was not imposed on S Corporation. With respect to FICA taxes, as would any corporation, S Corporation may file a refund claim for FICA taxes subject to the administrative requirements under sections 6402 and 6413 of the Code and the regulations thereunder.

2. The Receiver's actions satisfy S Corporation's duty to first adjust overpaid employee FICA tax. The Receiver notified the Shareholder of his intention to file a refund claim for employment taxes. Having notified the Shareholder, and being aware that Shareholder refused to consent to the filing of the refund claims, the Receiver was permitted to file refund claims with respect to the employer's share of the FICA tax.

3. Regardless of whether the Receiver has standing to file a refund claim, income taxes withheld in prior years from wage payments cannot be refunded to S Corporation.

FACTS:

The taxpayer ("S Corporation") operated as a subchapter S corporation during . S Corporation's business was . S Corporation's sole shareholder ("Shareholder") was an officer and employee of S Corporation during .

In , the brought an enforcement action against Corporation and Shareholder to enjoin them from further operation of Corporation's business. The district court issued an order of permanent injunction and disgorgement. In addition, the court appointed a receiver ("Receiver"). The injunction order states in relevant part,

> D. IT IS HEREBY FURTHER ORDERED that [Receiver], Esq. is appointed equity receiver ("Receiver"), with the full power of an equity receiver, for the purpose of performing an accounting, determining the amount of disgorgement made by defendants, and preparing a plan for

> disbursement of the disgorgement amount to defendant's customers, and such other tasks as the court deems necessary and appropriate under the circumstances . . . .
>
> F. IT IS HEREBY FURTHER ORDERED that the Receiver shall conduct, perform, or supervise an accounting of all assets and liabilities of defendants, together with all funds received and paid out, in or in connection with all transactions, from the date of their receipt beginning , until the date of such accounting, together with an accounting of all salaries, commissions, fees, loans, and other disbursements of money and property of any kind, in or in connection with transactions, from , until the date of such accounting.

The Receiver determined that deductions taken on S Corporation's income tax return for were not allowable to the extent that the compensation paid to the Shareholder was more than reasonably allowable. Receiver filed a . In response, Shareholder filed motions objecting to the Receiver's notice. Shareholder raised several objections, including that the Receiver did not have standing because he reported S Corporation's net income on his individual income tax return. The district court declined to interfere with the Receiver's intent to file amended federal tax returns. The Receiver therefore filed a refund claim for income tax withheld and for the S Corporation's share of FICA tax paid with respect to the unreasonable amount.

LAW AND ANALYSIS

1. Whether the Receiver of S Corporation has standing to file a refund claim for income tax withheld, and FICA tax withheld and paid, with respect to the unreasonable portion of the salary paid to Shareholder.

You have asked for advice given the assumption that the Receiver is correct that the amount of compensation paid was unreasonable. Given that assumption, the following considers first whether a receiver generally has standing to file an amended federal tax return on behalf of an S corporation, and more specifically, whether a receiver may file a claim for refund of employment taxes withheld and paid by an S corporation.

With exceptions, a corporation that has elected to be treated as an S corporation is not taxed as a corporation on its income. I.R.C. § 1363(a). Section 1.1363-1(a)(1) of the Income Tax Regulations provides that a small business corporation that makes a valid election under section 1362(a) is exempt from the taxes imposed by

chapter 1 of the Internal Revenue Code, i.e., the income tax, with respect to taxable years of the corporation for which the election is in effect. The effect of this provision is that items of income, losses, deductions, and credits pass through to and are attributed to the individual shareholders.

For purposes of the Federal Insurance Contribution Act (FICA), sections 3101 and 3111 of the Code impose a tax on the wages paid by employers to employees with respect to "employment." The FICA tax comprises two separate taxes. Sections 3101(a) and 3111(a) of the Code impose Old-Age, Survivor's, and Disability Insurance (OASDI) taxes and sections 3101(b) and 3111(b) impose Hospital Insurance (HI) taxes on employees and employers, respectively.

Section 6012(b)(3) of the Code provides that a receiver shall make the return of income for a corporation in the same manner and form as corporations are required to make such returns. Section 6012(a)(1) requires that returns with respect to income taxes shall be made by every individual and section 6012(a)(2) requires that returns with respect to income taxes shall be made by every corporation subject to income taxation. Section 6037 provides that an S Corporation shall make a return setting forth its items of gross income and deductions and the amounts distributed to each shareholder.

Alon International, Inc. v. United States, 910 F. Supp. 233 (W.D. Pa. 1995), considered whether a corporation that purchased the stock of an S corporation may amend the income tax return of the S corporation for a return period ending before it purchased the stock. The court held that it could not. The court noted that section 6511(a) provides that “a claim for ... refund ... shall be filed by the taxpayer.” The court further noted that section 7701(a)(14) defines a taxpayer as “any person subject to any internal revenue tax,” and that section 7701(a)(1) provides that the term “person” includes individuals and corporations. The court reasoned that the purpose of the S corporation provisions under sections 1361 through 1379 is to pass through and attribute to the shareholder the corporate income, losses, deductions, and credits; and thus the shareholder was the “taxpayer” and any increase or decrease in tax was his obligation. Accordingly, the court held that the corporation lacked standing to file an amended return; rather, the shareholder was the person responsible for filing the amended return because it was his return on which the income tax attributable to the S corporation was due.

A reading of Alon International, Inc., to the effect that because section 7701(a)(14) defines a “taxpayer” as “any person subject to any internal revenue tax,” only a person directly liable for the tax can have standing to bring a refund suit, should be regarded as overly broad in light of United States v. Williams, 514 U.S. 527 (1995). There, the Service assessed a tax against Jerald Rabin and placed a lien on the

home jointly owned with his then wife, Lori Williams. Jerald transferred his interest in the home to Lori in a division of assets in contemplation of divorce. Though not personally liable for the tax, Lori paid under protest to remove the lien. She sued for a refund under 28 U.S.C. § 1346(a)(1), which waives sovereign immunity in a civil actions for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected.

The Government contended that Lori lacked standing to seek a refund because she had not been assessed with the tax deficiency. The Supreme Court held that 28 U.S.C. § 1346(a) authorizes a refund suit by a party who paid under protest to remove a tax lien, even though the party was not the party assessed. The Supreme Court rejected arguments under the Internal Revenue Code which the Government made to bolster its interpretation of 28 U.S.C. § 1346(a)(1). With respect to I.R.C. § 6511(a) , which sets the period of limitations for filing a refund claim and states that the claim shall be filed "by the taxpayer" rather than the person who paid the tax, the Supreme Court commented that section 6511(a) set a deadline, not a limit on who may file.

With regard to section 7701(a)(14), which provides that the term "taxpayer" means "any person subject to any internal revenue tax," the Supreme Court reasoned that "subject to" is broader than "assessed." The Supreme Court read a person "subject to" the internal revenue tax as including a person who made a tax payment under protest with regard to a lien on her home. Interestingly, the Supreme Court rejected the Government's reading of the comment in Colorado National Bank of Denver v. Bedford, 310 U.S. 41, 52 (1940), that "[t]he taxpayer is the person ultimately liable for the tax itself." That case held that a service tax which the State of Colorado imposed fell on bank customers, though the bank collected and paid the tax. The Supreme Court stated that in Colorado National Bank, they were not interpreting the term "taxpayer" in the Internal Revenue Code. The Supreme Court commented that if Colorado National Bank was at all relevant, it favored common sense over formalism.

Williams does not change the application of Alon International, Inc. to the present facts. Shareholder is the person ultimately liable for the income tax with respect to the items passed through from the S Corporation for 1996. Thus, we conclude that the Receiver lacks standing to file a refund claim for income tax withheld.

With regard to FICA tax withheld and paid with respect to wages paid to Shareholder, S Corporation is treated as the employer responsible for withholding and paying the FICA taxes imposed under sections 3101 and 3111 of the Code. S corporation status generally has no affect on the application of the FICA tax

provisions.[1] Thus, if amounts paid were not in fact "wages," the Receiver is entitled to file a claim for refund provided that, as discussed below, the requirements under sections 6402 and 6413 and the regulations thereunder were satisfied.

2. Whether the Receiver's actions satisfy S Corporation's duty to first adjust overpaid employee FICA tax before filing a refund claim for its portion of the FICA tax.

Section 6413(a) of the Internal Revenue Code provides that if more than the correct amount of employer or employee FICA tax is paid on any payment of remuneration, proper adjustments, of both the tax and the amount to be deducted must be made, without interest, as prescribed by regulations.

Section 6413(b) of the Code provides that if more than the correct amount of employer or employee FICA tax is paid on any remunerations, and the overpayment cannot be adjusted under section 6413(a), the amount of the overpayment must be refunded as prescribed by regulations. Section 31.6413(b)-1 of the Employment Tax Regulations refers to sections 31.6402(a)-1 and 2 for provisions relating to refunds of employer and employee FICA tax.

Section 31.6413(a)-1(b)(1)(i) of the regulations provides that when the employer ascertains that it has paid more than the correct amount of employee tax under section 3101 after the return reporting the payment has been filed, the employer "shall repay or reimburse the employee" if the error is ascertained within the applicable limitations period. However, the employer is exempted from the refund requirement if the overcollection and overpayment to the district director is "made the subject of a claim . . . for refund or credit, and the employer elects to secure the written consent of the employee to the allowance of the refund or credit under the procedure provided in [§ 31.6402(a)-2(a)(2)(i)]."

Section 31.6402(a)-2(a)(2)(i) of the regulations provides that every claim for refund or credit of employee tax under section 3101 collected from an employee

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[1]Revenue Ruling 73-361, 1973-2 C.B. 311, holds that an S corporation does not lose its identity by reason of a small business corporation election, but remains a legal corporate entity. See also, Fred R. Esser, P.C. v. United States, 750 F. Supp. 421 (D Ariz. 1990). and Joseph Radtke, P.C. v. United States, 712 F. Supp. 143 (E.D. Wis. 1989), aff'd 895 F.2d 1196 (7th Cir. 1990) (the courts considered whether S corporations were entitled to refunds of employment taxes paid on dividend payments to shareholders which were reclassified by the Service as wages. In both cases there is no suggestion that the corporation which filed the claim and brought suit lacked standing to do so).

shall include a statement that the employer has repaid the tax to such employee or has secured a written consent of such employee to the allowance of the refund or credit.

Section 31.6402(a)-2(a)(2)(ii) of the regulations provides that every claim filed by an employer for refund or credit of employee tax must include a statement that the employer has repaid the tax to the employee or has secured the written consent of the employee to the allowance of the refund or credit. If the claim relates to employee tax collected in a year prior to the year in which the credit or refund is claimed, the employer must also submit a statement that it has obtained from the employee a written statement (a) that the employee has not claimed refund or credit of the amount of the overcollection, or if so, such claim has been rejected, and (b) that the employee will not claim refund or credit of such amount. Thus, the employer must obtain the employee's consent and also must obtain a written statement.

In Atlantic Department Stores, Inc. v. United States, 557 F.2d 957 (2d Cir. 1977), the court considered whether the Service had to honor refund claims for overpaid employer FICA tax that were submitted by an employer who had taken no action to enable its employees to recover the corresponding overpayment of employee FICA tax. The court held that the legislative history of section 6413 of the Code and the regulations under sections 6402(a) and 6413(a) established an obligation for the employer to first adjust the overpayment of employee tax with its employees and then claim a credit or refund from the Service. Atlantic Department Stores did not directly consider whether securing employee consents or attempting to secure employee consents to the allowance of refunds in accordance with section 31.6402(a)-2 of the regulations would fulfill this duty to first adjust overpaid employee FICA tax.

Revenue Ruling 81-310, 1981-2 C.B. 241, considered whether attempting to secure employee consents to the allowance of refunds in accordance with section 31.6402(a)-2(a)(2)(i) of the regulations would fulfill the employer's duty to first adjust overpaid employee FICA tax. The ruling holds that when the employer notifies its employees of the overpaid employee FICA tax, and requests their consents to its filing a refund claim on their behalf, it has made reasonable efforts to protect their interests. Thus, for purposes of the principle recognized in Atlantic Department Stores, the employer's request for employee consents should be treated as fulfilling its duty to "adjust" employee overcollection. Thus, even if the employer's reasonable effort to secure consents or statements is unsuccessful, the employer may claim a refund of the overpaid employer portion of the FICA tax.

The question therefore arises in this case whether the Receiver fulfilled S Corporation's duty to adjust the amount of the overcollection from the Shareholder. Based upon Rev. Rul. 81-310, the Receiver must have at least made reasonable efforts to protect the Shareholder's interests. The Receiver filed a Notice of Intention to File Amended Tax Returns. In response, the Shareholder filed motions objecting to the Receiver's motion. The Shareholder's motions in response were effectively refusals to furnish a consent or statement as required under section 31.6402(a)-2(a)(2) of the regulations. Therefore, Receiver's actions fulfilled S Corporation's duty to first attempt to "adjust" the account of the employee. Accordingly, the Receiver may claim a refund of the employer's portion of FICA imposed under section 3111.[2]

3. Whether income tax withheld by S Corporation in prior years from wage payments may be refunded to S Corporation regardless of whether or not Receiver has standing to file a refund claim.

Section 6414 provides that in the case of an overpayment of income tax imposed by Chapter 24 (Collection of Income Tax at Source on Wages), refund or credit shall be made to the employer only to the extent that the amount of such overpayment was not deducted and withheld by the employer. Although the employer may adjust the amount of income taxes withheld to account for an overpayments within the same year as the overpayment, section 6414 generally precludes the employer from claiming a refund on its own behalf of income taxes which have actually been withheld from an employee's wages. Therefore, S Corporation is not entitled to a refund of income tax withheld regardless of whether the Receiver had standing to file a refund claim.

Revenue Ruling 77-464, 1977-2 C.B. 474, does not change this conclusion. Rev. Rul. 77-464 considers whether an employer is entitled to a refund of income taxes withheld on amounts paid to fictitious employees. The ruling holds that embezzled amounts paid to fictitious employees do not constitute wages for purposes of employment taxes since embezzled amounts are not remuneration for services as provided under section 3401(a). The ruling therefore concludes that the employer is entitled to a refund of income tax withheld. The facts in present case are distinguishable from the facts under the revenue ruling because the income tax was withheld from an actual employee and not from a fictitious employee. Thus, section

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[2]Section 31.6051-1(c)(1) of the regulations provides that when wages as defined in section 3121(a) or tax under section 3101, are incorrectly reported on a W-2 submitted to an employee, a corrected statement must be issued to the employee marked "corrected by employer."

6414 precludes the Receiver from receiving a refund of income tax withheld in a prior year from Shareholder's wages.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

We do not believe that there are any significant litigating hazards. However, it would be advisable to inform the court that the Service is aware of the broad reading given to the section 7701(a)(14) term "taxpayer" by the Supreme Court in Williams, supra, and does not consider this to change the effect of Alon International, Inc., supra.

If you have any further questions, please call (202) 622-6040.

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Associate Chief Counsel (Employee Benefits & Exempt Organizations)