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Assistant Commissioner (Taxpayer Services) T:T

Assistant Chief Counsel (Income Tax & Accounting)
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INCOME TAX AND ACCOUNTING

Credit Elect and Certain Bankruptcy Freeze Conditions

This is in reply to your November 20, 1995, memorandum concerning the credit elect and certain bankruptcy freeze conditions. Your memorandum explains that beginning January 1, 1997, the Financial Management Service (FMS) will become the administrator of the Tax Refund Offset Program (TROP).

The Service currently matches the debtor information to the overpayment disclosed on the taxpayers' returns after tax debts are satisfied and before any amount of the overpayment is applied to the taxpayer's succeeding year estimated tax liability (credit elect). Only if an amount of the overpayment remains after the various offsets will the Service honor a credit elect. Under the new system for administering the TROP, the Service will provide refund data to FMS. FMS will match the debtor information received from the creditor agencies to the Service-provided data and offset any support or past-due debt before issuing the refund to the taxpayer. However, the data will reflect refunds payable after any past-due taxes are offset and after any amount is applied pursuant to the credit elect.

I. Credit Elect.

Section 301.6402-3(a)(5) of the Regulations on Procedure and Administration provides, in part, that if a taxpayer indicates on its return (or amended return) that all or part of the overpayment shown by its return (or amended return) is to be applied to its estimated income tax for its succeeding taxable year, such indication shall constitute an election to so apply such overpayment, and no interest shall be allowed on such portion of the overpayment credited and such amount shall be applied as a payment on account of the estimated income tax for such year or the installments thereof.

Section 301.6402-3(a)(6) states that, notwithstanding § 301.6402-3(a)(5), the Internal Revenue Service, within the applicable period of limitations, may credit any overpayment of

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individual, fiduciary, or corporation income tax, including interest thereon, against--

1. First, any outstanding tax liability;

2. Second, amounts of past-due support assigned to a state;

3. Third, past-due and legally enforceable debt owed to Federal agencies; and

4. Fourth, qualifying amounts of past-due support not assigned to a state.

Section 301.6402-3(a)(6) reflects the order in which overpayments are applied pursuant to § 6402. Therefore, § 301.6402-3(a)(6) reflects the intent of Congress that an overpayment be treated in the manner elected by the taxpayer only after past due taxes and non-tax debts are satisfied.

Section 6513(d) provides that if any overpayment of income tax is, in accordance with § 6402(b), claimed as a credit against estimated tax for the succeeding taxable year, such amount shall be considered a payment of income tax for such succeeding taxable year (whether or not it is claimed as a credit on the estimated tax return for such succeeding taxable year), and no claim for credit or refund of such overpayment shall be allowed for the taxable year in which the overpayment arises.

Section 301.6402-3(a)(6) requires the Service to apply an overpayment to the succeeding year's estimated tax only after the overpayment is first applied to delinquent taxes or amounts subject to offset under the TROP. The Service is bound by an election once the overpayment is applied as a credit to the subsequent year estimated tax. See, for example, Rev. Rul. 77-339, 1977-2 C.B. 475, which provides (citing § 6513(d)) that once an overpayment has been credited to the subsequent year's estimated tax liability, then the amount loses its character as an overpayment and the Service cannot thereafter offset it against any subsequently determined tax liability.

Once all or part of the overpayment is applied as a payment of the succeeding year's estimated tax according to the taxpayer's election, the Service is precluded from applying the overpayment either to underpayments of tax or to the TROP items. The various creditor agencies will not have access to the full amount for offset that should be available under section 6402 of the Internal Revenue Code. We understand that this situation could be avoided if the Service identified returns showing a credit elect and gave FMS an opportunity to match the debtor file with those returns before the overpayment was credited to the

subsequent year's estimated tax liability. Alternatively, the Service and FMS could establish a data link so that the debtor file would be included in the settlement routine of an account so that the debt would be offset before the amount available for the credit elect was determined.

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II. Bankruptcy Freezes Conditions.

The Memorandum of Understanding (MOU) has established procedures for situations involving automatic stays under 11 U.S.C. § 362. The MOU states at C.2.(d)(ii) that the agency will refund any offset made in violation of the automatic stay. The MOU states at C.2.(e)(v) that the agency may not refer debts if the agency has notice of the filing of a bankruptcy petition and the automatic stay pursuant to 11 U.S.C. § 362 has not been lifted. The MOU at D.1.(d)(i) states that the Service will refund an offset to the debtor if the Service has knowledge that an automatic stay under 11 U.S.C. § 362 was in effect at the time of offset.

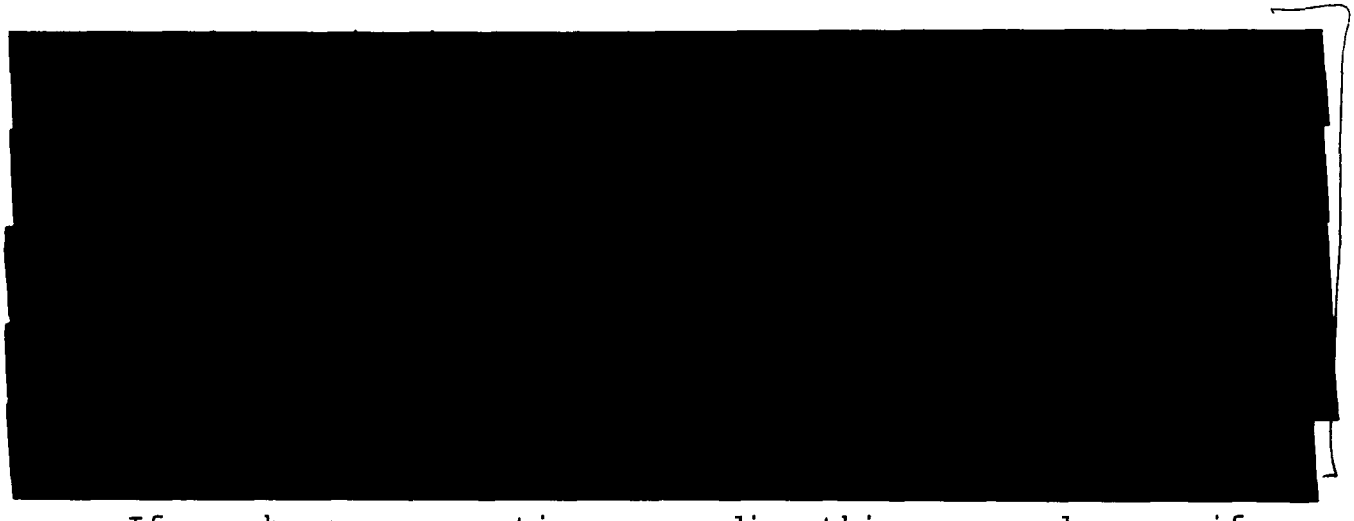
The Internal Revenue Manual (IRM) provides at 57(13)3.5(3), in part, that if the taxpayer owes no outstanding tax liability or if the overpayment exceeds the taxes owed, and an automatic stay has not been lifted, any credit balance subject to offset to past due child support or non-tax federal debts should be refunded to the taxpayer or turned over to the bankruptcy trustee in accordance with local procedures notwithstanding the non-tax debts.

IRM 57(13)3.5(4) provides that when research on a debtor refund inquiry discloses that offset to a child support or non-tax federal debt obligation has been made in violation of the automatic stay, a reversal of the offset should be made. The

reversal must be verified with the National Office to ensure that the agency is not in the process of issuing a refund. If the agency has not issued a refund, a reversal will be made. If the agency issued or is about to issue the refund, the taxpayer will be notified.

The MOU currently prohibits creditor agencies from referring debts to the Service as part of the refund offset program if an automatic stay is in effect. If an agency improperly refers a debt, and the Service makes an offset, then the agency is charged with the responsibility to make the refund to the taxpayer. If an agency is not aware of the automatic stay and refers the debt to the Service then the Service, if it has knowledge of the automatic stay, will not honor the offset request.

The Service can submit refund data to FMS that shows a bankruptcy freeze code only if the Service is aware of the bankruptcy. If the Service is aware that an automatic stay is in effect, then the affected taxpayer's refund should be processed according to current IRM procedures. See IRM 57(13)3.5(3). This is also consistent with the current MOU, which states that the Service will not honor an offset request if it has knowledge that an automatic stay is in effect.



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If you have any questions regarding this memorandum, or if you would like to meet to discuss it, please contact John McGreevy at 622-7506.

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