OFFICE OF
CHIEF COUNSEL

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

MEMORANDUM FOR DISTRICT COUNSEL, LOS ANGELES
CC:WR:LAD:LA

FROM: ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: Modified expedited refunds in Joint Committee cases with whipsaw issues

This Field Service Advice responds to your memorandum dated April 27, 2000. 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.

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LEGEND:

Authorized representatives:

X =

Y =

Z =

CORP S =

YEAR 1	calendar year	$A	$
YEAR 4	calendar year	$B	$
YEAR 5	calendar year	$C	$
		$D	$

ISSUE:

What discretion does the Service have to issue an expedited refund pending the completion of a tax examination after accepting a surety bond to secure the tax to be refunded, if a potential whipsaw situation precludes the Service from determining an overpayment?

CONCLUSION:

In considering a request for an modified expedited refund in a Joint Committee case, the Service may only refund the amount that is determined by the Service as the minimum amount of overpaid tax that is due to the taxpayer. If the determined refund exceeds $1 million, the refund must first be submitted for approval by the Joint Committee. If the Service cannot determine an overpayment of tax without creating a “whipsaw” situation because of the inconsistent treatment of the same item by the taxpayers involved in a transaction, the Service may not refund the claimed overpayment of tax to the taxpayer, even with Joint Committee approval.

FACTS:

Prior to YEAR 1, X, ——————, owned 100% of the stock of CORP S and several related corporations. ——————————————————————————————————. During YEAR 1, in lieu of a salary, CORP S and the related corporations each paid Z, an employee of each corporation, with their own stock pursuant to subscription agreements. At the end of YEAR 1, X retained the absolute ownership —— of each corporation's stock while X's ownership of the remaining —— of each corporation's stock was subject to Z's interest under the subscription agreement.

On Forms for YEAR 1, the corporations reported expenses totaling $A for the value of the salaries paid to Z pursuant to the subscription agreement.

In filing Z's income tax return for YEAR 1, however, Z elected under section 83(b) to report the "fair market value" of the corporate stock, which Z valued at $B, as income in YEAR 1. ——————————————————————————————————

transaction. Thus, until X ———, Z, and the Service agree to a value for the stock or a court conclusively determines that value, the Service cannot determine with certainty the amount of the claimed corporate expenses———————————————————————————————————.

The Service is preparing to issue a 30-Day Letter to Z, proposing a tax deficiency based upon a stock value of $C. Any action on X ’s claim for refund is being delayed pending completion of the audit of Z. That audit, plus, anticipated litigation, is not expected to be completed for at least another year.

X ——— have requested that the Service make an expedited refund of their claimed overpayment of income tax for YEAR 1 while the Service’s review of the refund claim is pending because the examination and litigation is not expected to be completed for at least one year. The requested refund exceeds $1,000,000. X ——— have offered to provide security in the form of a surety bond. [1]

[1] We are not reviewing the proposed surety bond.

LEGAL ANALYSIS

Section 6402(a) of the Internal Revenue Code is the sole Code provision that affirmatively authorizes the Service to make refunds to a taxpayer. Section 6402(a) provides that Service may "refund any balance" of any "tax overpayment" to a taxpayer after crediting the amount of such overpayment against any outstanding tax liabilities of the taxpayer. (emphasis added) An overpayment, although not exhaustively defined in the Code, is the amount by which a payment of tax exceeds the correct total amount of the taxpayer's liability for a tax period or any amount that was assessed or collected after the expiration of the applicable period of limitations. Section 6401; Jones v. Liberty Glass Co., 332 U.S. 524 (1948). The Service is not required or authorized by statute to refund tax payments claimed by a taxpayer if an overpayment has not been determined. Lewis v. Reynolds, 281 U.S. 201 (1932).

Section 6511 provides the limitations period within which a taxpayer must file a claim for refund of any tax overpayments. The general procedures for making an claim for refund of income tax are found in Treas. Reg. §§ 301.6402-2, 3. The Service will issue a refund under these procedures only if it determines, based upon the grounds set forth and detailed in a timely filed refund claim, that there is an overpayment of tax.

Section 301.6402-4 of the regulations, which addresses a claim for refund included on a tax return, provides one exception to the necessity that the Service first determine that there is an overpayment of tax before making a refund. If an overpayment is claimed on the taxpayer's return to recover payments made before the return was filed, the Service may "credit or refund [payments in excess of the amount of tax shown on the return] without awaiting examination of the completed return and without awaiting filing of a claim for refund." Implicit in this exception for refunds claimed on the return is the understanding that the Service must otherwise make a determination with respect to the validity of the taxpayer's refund claim before crediting or refunding claimed overpayments under section 6402.

Section 6411 also provides a special procedure under which a taxpayer may apply for the tentative carryback adjustment of tax for a prior taxable year affected by certain carrybacks from another taxable year. Because the Service must quickly respond to these carryback applications, the Service makes a limited review of the application only for material omissions and computational errors before either disallowing the application or making a tentative refund under section 6411. Treas. Reg. § 1.6411-3(b). The application for a carryback adjustment must be filed within twelve months after the source year in which the loss or credit to be carried back arose. Except for determining overpayment interest, the application is not a claim for credit or refund. Section 6411 (last sentence); see Thompson v. United States, 99-1 U.S.T.C. ¶ 504,886 (Fed. Cl. 1999); Thrif-Tee, Inc. v. United States, 492

F.Supp. 530 (N.C. 1979), aff'd without pub. op., 638 F.2d 1351 (4th Cir. 1980). X 's refund claim is not an application under section 6411.

In general, except with respect to refunds claimed on the taxpayer's original tax return or on an application for tentative carryback on which a taxpayer claims an overpayment of tax, the Service does not make refunds of tax, unless it has first determined that there is an overpayment of tax to be refunded. Refund claims submitted pursuant to Treas. Reg. §§ 301.6402-2 and 3, do not, in themselves, provide a basis for making a refund of tax, until the Service determines that an overpayment exists and that the taxpayer is entitled to the refund.

In this case, the possibility of being whipsawed precludes the Service from making a determination that X have overpaid their income tax for YEAR 1 based upon their claim for refund. A whipsaw occurs when taxpayers treat the same transaction involving the same income inconsistently, thus creating the possibility that the income might go untaxed. See Bouterie v. Commissioner, 36 F.3d 1361, 1373-74 (5th Cir. 1994), Wickert v. Commissioner, 842 F.2d 1005 (8th Cir., 1988), Streber v. Hunter, 14 F.Supp.2d 978, 981 (W.D. Tex. 1998). When presented with possible whipsaws, the Service is substantially justified in taking contradictory protective positions to protect the revenue. Dooley v. Commissioner, T.C. Memo. 1992-557; Wickert v. Commissioner, T.C. Memo. 1986-277, aff'd, 842 F.2d 1005 (8th Cir. 1988). In view of the sizable difference between the values ascribed to the fair market value of the – corporation stock paid by the corporations to Z in YEAR 1, the Service cannot determine an overpayment and make a refund of tax

If the Service were to allow X 's claim for refund based upon their $C valuation of the stock without first obtaining a binding agreement from Z, a court could later determine that Z's $B valuation was correct. The Service, in order to make the tax liability from the transaction consistent, would then be compelled, if the appropriate limitations periods had not expired, to sue for the return of an erroneous refund from X ——— or to propose a new deficiency in tax for X ———, which could itself be subject to further litigation.[2] It is in the best interest of the Service to either finally resolve the value of the stock with both parties to the transaction or to take inconsistent protective positions that can be brought to a court for resolution. See Arnes v. Commissioner, 102 T.C. 522, 530 (1994), in which the Tax Court criticized the service failure to "take action to facilitate simultaneous consideration" of the two

[2] Notably, because section 6532(b) gives the Service only two years after a refund is made to sue to recover an erroneous refund, the Service may have to file suit to protect its right of recovery from X ——— before this issue could be resolved with Z.

sides of a whipsaw case in which both parties escaped taxation on the transaction.

X ——— assert that the Service procedures for making expedited refunds in Joint Committee cases provide a process for the Service to make a refund, before it completes its examination of the section 83 issue or the other issues in the audit of X 's YEAR 1 income tax return. We do not agree. The provisions of IRM 4.3.5, the Joint Committee Handbook (4/30/99), provide the Service's current procedures for submitting proposed refunds for approval by the Joint Committee in implementation of section 6405(a). Section 6405(a) supplements the refund authorization in section 6402 by prohibiting the refund or credit of income tax in excess of $1,000,000 until after a report is submitted to the Joint Committee on Taxation. Neither section 6405 nor the Joint Committee Handbook permit the making of refunds that are not authorized under section 6402.

Under the normal Joint Committee review procedure, a report is prepared and a case is submitted for Joint Committee review only if there is a net overpayment to be refunded or credited to the taxpayer in excess of $1 million after the Service has completed an examination of one or more tax years. A "regular report" is used if refunds have already been made (e.g., in response to a section 6411 tentative refund claim) so that less than $1 million is left to be refunded, and an "expedited report" is made if there is a net unpaid refund in excess of $1 million to be made. See IRM 4.3.5.1.2; 4.3.5.5.2; and 4.3.5.5.3. A "supplemental report" is filed if further adjustments are made after one report has been filed. See IRM 4.3.5.5.5.

IRM 4.3.5.5.4 also provides for a "modified expedite refund report" to be prepared when the Service has not completed action on a case. Chapter 6 of the Joint Committee Handbook contains the procedures for using the modified expedited report. Per this chapter, the modified expedite refund report may be used when there are "unagreed issues, as shown in Section 6.2" or "unexamined source years, as shown in section 6.3." Cases involving unagreed issues are those in which the taxpayer and the Service are prepared to make a partial agreement for the assessment or abatement of some tax liabilities without resolving all of the pending issues for a tax period. Cases involving unexamined source years are those in which the Service and the taxpayer have resolved the issues for the tax year with the exception of carrybacks or carryforwards from other "source years" that are still being examined. In both situations, the modified procedures are authorized for use in obtaining Joint Committee approval for an "expedited refund" without waiting for the completion of survey or examination action to be completed. IRM 4.3.5.6.5.

Chapter 6 of the handbook requires certain conditions to be met before a "modified expedited refund report" can be prepared and sent to the Joint Committee:

A. There must be a claimed section 6405(a) refund amount subject to Joint Committee Review in excess of $1,000,000.00 in an unexamined or unsurveyed source or carryback year, IRM 4.3.5.6.5.1;

B. The examination of the unagreed issues or the source year will require a substantial period of time (six months or more) to resolve, and "the delay would deprive the taxpayer of a timely refund to which the taxpayer is clearly entitled," IRM 4.3.5.6.5.1, 4.3.5.6.2(1), and 4.3.5.6.3(1);

C. The taxpayer must post an acceptable bond or similar security, IRM 4.3.5.6.5.1 and IRM 4.3.5.6.3(1);

D. The report must contain an explanation of why the refund is being issued before the case is completed or surveyed, including a conclusion that no disadvantage to the government will occur as a result of the early refund, IRM 4.3.5.6.5.2, 4.3.5.6.2(2), and 4.3.5.6.3.(2);

E. The refund may reflect only the minimum amount to which the taxpayer is entitled, regardless of the outcome of the unagreed issue, IRM 4.3.5.6.2(1), 4.3.5.6.2.(4), 4.3.5.6.3(1), and 4.3.5.6.3(5);

F. A supplemental report must be submitted at the end of the examination or survey, IRM 4.3.5.6.2(3) and 4.3.5.6.3(4); and

G. The refund may not be one involving tentative refunds. IRM 4.3.5.6.2(1) and 4.3.5.6.3(2).

The key requirement for both unagreed issue cases and unexamined source year cases is that the modified expedite report procedures apply only to "the minimum amount to which the taxpayer is entitled" and only if that amount is over $1 million. IRM 4.3.5.6.2(1). In this case, the amount claimed by X ——— is over $1 million, but the Service has not determined that X ——— are entitled to recover any portion of that claimed amount. Before determining that X ——— are entitled to the refund of any portion of the amount claimed by them, the Service will need to determine the validity of Z's section 83(b) election and the fair market value of the stock of the S corporations that was transferred to Z by the corporations in Year 1. Until those determinations are made and some of X 's tax liabilities are abated, there is no overpayment of tax to be refunded.

The "modified expedited refund report" process only applies if the Service has agreed that the taxpayer is entitled to a refund of an tax overpayment in excess of $1,000,000. In this case, where the Service has not agreed that X are

entitled to a refund, there is no provision in the Joint Committee Handbook for making a provisional refund based upon the taxpayers' claim. Since the taxpayers did not claim the refund on their original return and did not timely file a claim under section 6411 for a tentative refund for a carried back adjustment, the Service must first determine an overpayment before a refund can be made.

Chapter 6 of the Joint Committee Handbook (rev. 4/30/99) revised the language manual provisions concerning modified expedited refunds, but no substantive changes were made. See Manual Transmittal 4.3.5. Ch.6 (4/20/99). Although use of the modified expedited report procedures had been authorized at IRM 457(10).5, revised 5/14/90, whenever a taxpayer requested that a refund be made prior to the completion of survey or examination action, the statutory limitations of section 6402 were implicit. These procedures could be applied where:

A. A refund was claimed in excess of $25,000;

B. Any examination or survey action was not expected to be completed within six months;

C. A modified expedite refund request report was sent to the Joint Committee;

D. The taxpayer posted bond or other security, as required by the Service, to secure repayment, if necessary, of the tax being refunded;

E. The taxpayer provided an executed written security agreement; and

F. The Service found that no disadvantage to the government would occur.

Since the Service is not authorized to refund tax unless the tax is overpaid, the Service's determination that the taxpayer is entitled to a refund is a condition precedent for finding that there is no disadvantage to the government. Like the current manual provisions, the former manual provisions provided a mechanism under which the Service could expeditiously make a refund subject to Joint Committee approval based upon a partial agreement, rather than waiting until all adjustments were completed for a tax period.

Nevertheless, some taxpayers may have interpreted the failure to include an express limitation prohibiting refunds unless there was a Service determination of an overpayment of tax as an indication that refunds could be made solely if claimed by a taxpayer. Under this misinterpretation, taxpayers claiming refunds of more than $1 million would be able to obtain an immediate refund of any taxes previously paid by claiming a refund and posting a bond. Because section 6402 does not

authorize such refunds, we do not believe that this interpretation of either the former or current manual provisions is correct.

On the facts presented, the Service does not have the authority to make a refund of tax in exchange for a bond or other security unless it first determines that there is an overpayment of tax to be refunded to the taxpayer. The Service has not determined that X overpaid their tax liability for YEAR 1. Thus, no portion of the previously paid tax liability may be refunded to X under the expedited refund procedures for Joint Committee cases.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

Please call if you have any further questions.