



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

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Assistant Chief Counsel (Field Service Division)
Procedural Branch CC:DOM:FS:PROC

SUBJECT: Claim for refund of tax paid by credit

This Field Service Advice responds to your memorandum dated July 7, 1998. 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:

A&B

Representative:

YEAR 1
YEAR 2
YEAR 3

YEAR 4
YEAR 5
YEAR 6

YEAR 7
 YEAR 8
 YEAR 9
 YEAR 10

DATE C	Date Tax Court decision entered for YEAR 1 and YEAR 2
DATE D	Date deficiencies and restricted interest assessed for YEAR 1 and YEAR 2
DATE E	Date on which overpayments for YEAR 7 through YEAR 10 were allowed
DATE F	Date on which additional interest was assessed for YEAR 1 and YEAR 2
DATE G	Date on which YEAR 7 through YEAR 10 taxes were abated
DATE H	Date (per A&B) on which overpayments from YEAR 7 through YEAR 10 were credited; the actual date may be earlier
DATE I	Approximate date on which informal claim for refund of overpayment was first filed for YEAR 1 and YEAR 2
DATE J	Date on which restricted interest was abated YEAR 1 and YEAR 2
DATE K	

ISSUES:

1. Whether the portion of a tax overpayment that has been credited against the outstanding assessed liability for another tax year may be refunded to or credited to another liability of a taxpayer if the taxpayer failed to file a timely claim for refund of the assessed liability against which the initial overpayment was credited.
2. If the refund or credit of the taxpayers' overpayments is not barred by the statute of limitations, may such overpayments be credited against the agreed upon tax deficiency in the Tax Court case, and, if so, what language should be used in the Stipulation and Decision documents to reflect such credit to the docketed tax year?

CONCLUSIONS:

1. Because the initial overpayment was properly credited to the outstanding assessed liability of the taxpayer for another tax year, it cannot be refunded or credited based upon a claim that the assessed liability against which it

was credited was incorrect unless the taxpayer files a timely claim for refund for the tax year to which the credit was made.

2. Since a refund or credit of the petitioners' overpayments for Year 1 and Year 2 are barred by the statute of limitations, the second issue is moot as to overpayments in those years. Computation of the tax liability for YEAR 3 should take into account the portion of the YEAR 9 and YEAR 10 overpayments that were credited as advance payments to YEAR 3 after the Tax Court petition was filed.

FACTS:

The taxpayers, A&B, are the petitioners in a currently pending United States Tax Court case involving YEAR 3 through YEAR 6. A&B and the Internal Revenue Service ("Service") have agreed that petitioners are liable for a deficiency in tax for each of the tax years at issue. A&B have requested that purported overpayments from YEAR 7 through YEAR 10 be applied to the deficiencies determined for YEAR 3 in the Tax Court case.

Previously, A&B were petitioners in a Tax Court case covering YEAR 1 and YEAR 2. Deficiencies for YEAR 1 and YEAR 2 were determined in a stipulated decision document dated DATE C. The deficiencies were assessed on DATE D, together with deficiency interest. An additional deficiency interest assessment was made on DATE F.

In connection with the same transaction involved in the Tax Court case, A&B filed a claim for refund for taxes paid for YEAR 7 through YEAR 10. At or about the time the YEAR 1 and YEAR 2 assessments were being made, the Service notified A&B that it was endeavoring to have any refunds for YEAR 7 through YEAR 10 generated as soon as possible and that it was putting a collection freeze on the underpaid accounts for YEAR 1 and YEAR 2 so that the overpayments from the later years could be credited against the YEAR 1 and YEAR 2 deficiencies. By letters dated DATE E, the Service told A&B that their overpayment claims for YEAR 7 through YEAR 10 were being allowed. The letters each stated that,

We will adjust your account for the amount of the refund to be issued, provided you owe no other taxes. Your refund check will include any interest due you, as provided by law.

The overpaid taxes for YEAR 7 through YEAR 10 were abated on DATE G. During the week of DATE H, the Service credited the overpayments from YEAR 7 through YEAR 9 against the outstanding tax liabilities, including interest, that had been assessed for YEAR 1 and YEAR 2. The remaining overpayment from YEAR 9 and all of the overpayment from YEAR 10 was applied, pursuant to a request from A&B,

as an advance payment against the tax for YEAR 3, for which A&B had filed the petition in the current Tax Court case. The representatives for A&B in the current and earlier Tax Court proceedings aver that the Service never notified A&B of the interest computations for YEAR 1 and YEAR 2 or the application of the overpayments from YEAR 7 through YEAR 10 among the assessed and proposed tax liabilities for YEAR 1 through YEAR 3. The Service has no record of providing such notice nor of any request from A&B for such information prior to DATE I.

In making the credits from YEAR 7 through YEAR 9 to YEAR 1 and YEAR 2, the Service correctly allowed no overpayment interest under I.R.C. § 6611(b)(1). The Service erred, however, in failing to abate interest for YEAR 1 and YEAR 2, as required by I.R.C. § 6601(f), that had accrued from the due dates of the YEAR 7 through YEAR 9 returns (when the overpayments arose) through DATE F. Thus, a portion of the YEAR 7 through YEAR 9 overpayments was used to satisfy an excessive assessed underpayment of interest.

On about DATE I, while the parties were preparing settlement documents in the current Tax Court case, A&B first notified the Service that the interest on the deficiencies for YEAR 1 and YEAR 2 was not properly adjusted when the overpayments from YEAR 7 through YEAR 9 were credited against them on DATE H. DATE I is more than two years after DATE H.

The Service, pursuant to A&B's request, partially abated the restricted interest on A&B accounts for YEAR 1 and YEAR 2 on DATE J, creating credit balances for those years. The abatements were based upon the Service's agreement that the restricted interest for YEAR 1 and YEAR 2 should have been recomputed and reduced based upon the crediting of the YEAR 7 through YEAR 9 overpayments against the YEAR 1 and YEAR 2 deficiencies. A&B now assert that they are entitled to a refund of such overpaid restricted interest for YEAR 1 and YEAR 2 or that they are entitled to a refund of the portion of the YEAR 7 through YEAR 9 overpayments that was "improperly" credited to the excessive YEAR 1 and YEAR 2 interest assessments. They have requested that the overpayments for those years be applied to their tax liability for the docketed YEAR 3.¹

¹ The amounts of the overpayments for YEAR 1 and YEAR 2 are not in issue.

LAW AND ANALYSIS

1. Whether the portion of a tax overpayment that has been credited against the outstanding assessed liability for another tax year may be refunded to or credited to another liability of a taxpayer if the taxpayer failed to file a timely claim for refund of the assessed liability against which the initial overpayment was credited.
 - A. The Service properly credited the overpayments against A&B's tax liabilities for YEAR 1 and YEAR 2.

The Service is authorized to refund overpayments of tax to taxpayers under I.R.C. § 6402(a). The regulations under section 6402, at Treas. Reg. § 301.6402-2, instruct taxpayers to file claims for refund if they determine that the tax for a particular period has been overpaid. In lieu of actually refunding such overpayments to a taxpayer, I.R.C. § 6402(a) allows the Service to credit an overpayment against existing liabilities when it provides:

In the case of any overpayment, the Secretary, within the applicable period of limitations, may credit the amount of such overpayment, including any interest thereon, against any liability in respect of an internal revenue tax on the part of the person who made the overpayment and shall, subject to subsections (c) or (d), refund any balance to such person.

No credit or refund of an overpayment can be made, however, after the expiration of the statute of limitations on refunds unless, before the expiration of the statutory period, the taxpayer files a claim for refund with the Service. I.R.C. § 6511(b)(1).

A&B filed timely claims for refund of tax overpayments for the YEAR 7 through YEAR 10. These claims were allowed as of DATE E. As A&B's overpayments for YEAR 7 through YEAR 10 were allowed, the Service was authorized to credit those overpayments against any outstanding liabilities of A&B before refunding the balance to A&B.² As anticipated by A&B, the Service credited a portion of those payments to the outstanding tax and interest assessed on DATE D following the settlement of the Tax Court case for YEAR 1 and YEAR 2. Accordingly, as reflected in the transcript of accounts for YEAR 1 and YEAR 2, the YEAR 7 through

² I.R.C. § 6402(c), (d), and (e) also require the Service to reduce the amount of any overpayment that may be refunded or credited to a future liability by the amount of any past-due support, any legally enforceable debt to a Federal agency, or any past due legally enforceable state tax liability owed by that person. To the best of our knowledge, those provisions are not relevant in this case.

YEAR 9 overpayments were applied on DATE H against and completely paid the assessed tax and interest for YEAR 1 and YEAR 2. The balance of the overpayments from YEAR 9 and YEAR 10 were similarly applied, at the direction of A&B, as advance payments of tax for YEAR 3.

- B. The Service erred in not abating a portion of the assessed underpayment interest for YEAR 1 and YEAR 2 when the credits were made, but properly and timely assessed both tax and interest.

When an overpayment is credited against another tax liability, I.R.C. § 6611(b)(1) provides that interest is to be allowed and paid on the overpayment “from the date of the overpayment to the due date of the amount against which the credit is taken.” The taxes for YEAR 1 and YEAR 2 were due, respectively, as of DATE K for the years following YEAR 1 and YEAR 2, and the overpayments for YEAR 7, YEAR 8, and YEAR 9 arose as of DATE K for the years following YEAR 7, YEAR 8, and YEAR 9, respectively. Because the due dates for YEAR 1 and YEAR 2 preceded the dates on which the overpayments arose, there was no period on which overpayment interest was allowable. In contrast, I.R.C. § 6611(b)(2) allows interest on refunds from the date the overpayment arises until a date preceding the date of a refund check by no more than 30 days. A&B would have been entitled to overpayment interest if their YEAR 7 through YEAR 9 overpayments had been refunded to them, rather than credited against the YEAR 1 and YEAR 2 liabilities.

As of DATE F, the Service had correctly assessed the underpayment interest owed by A&B on the tax underpayment for YEAR 1 and YEAR 2. I.R.C. § 6601(a) provides that interest on an underpayment of tax that is not paid on or before the last date prescribed for payment accrues from the prescribed payment date until the date on which the tax is paid. Section 6601(e) provides that the interest on any tax—

shall be assessed, collected and paid in the same manner as taxes. Any reference in this title (except . . . deficiency procedures) to any tax imposed by this title shall be deemed to refer to interest imposed by this section on such tax.

Interest on a tax may be assessed and collected at any time during the period within which the tax to which such interest relates may be collected. I.R.C § 6601(g). Since neither A&B’s tax for YEAR 1 and YEAR 2 nor the accrued interest on such tax had been paid as of DATE F, both the tax and the underpayment interest were properly assessed tax liabilities for those years.

To parallel section 6611(b)(1), however, I.R.C. § 6601(f) provides that:

[i]f any portion of a tax is satisfied by credit of an overpayment, then no interest shall be imposed under this section on the portion of the tax so satisfied for any period during which, if the credit had not been made, interest would have been allowable with respect to such overpayment.

Under this provision, when the Service credited the YEAR 7 through YEAR 9 overpayments against the YEAR 1 and YEAR 2 tax liabilities, the assessed underpayment interest for YEAR 1 and YEAR 2 should have been reduced by the amount that had accrued during the period when overpayment interest was not allowed on the YEAR 7 through YEAR 9 overpayments. Thus, since overpayment interest was not allowed after the due dates of the YEAR 7 through YEAR 9 returns, accrual of underpayment interest for YEAR 1 and YEAR 2 should have stopped as of the due dates of the YEAR 7 through YEAR 9 taxes from which the YEAR 1 and YEAR 2 underpayments were paid. The Service erred in not making those abatements when the credits were processed.

- C. The tax overpayments attributable to the Service error exist in YEAR 1 and YEAR 2, and are subject to a refund claim for those years, not to correction through other actions for YEAR 7 through YEAR 10.

It has been long established that the crediting of an overpayment of tax from one year against an underpayment of tax for another year constitutes a payment of tax as effectively as a payment of the underpaid tax in cash. McEachern v. Rose, 302 U.S. 56 (1945); United States v. Swift & Co., 282 U.S. 468 (1931), United States v. Botany Worsted Mills, 98 F.2d 880 (3d. Cir. 1938). Inasmuch as the amount of the credit is transferred from the overpaid account as full or partial payment of the underpaid account, the credited amount ceases to be a payment in the first account and can no longer be an overpayment in the overpaid account. In this case, the tax liabilities for YEAR 7 through YEAR 10 were no longer overpaid once the Service credited the overpayments in those accounts to the assessed underpayments for YEAR 1 and YEAR 2 and, at A&B's request, as advance payments of A&B's liability for YEAR 3.

Once an overpayment has been credited in payment of another tax liability, the proper remedy for contesting the validity and legality of the tax against which the overpayment has been credited lies in a timely claim for refund of the tax paid by means of the credit. Treas. Reg. § 301.6402-2; see Donahue v. United States, 33 Fed. Cl. 600 (1995). As relevant herein, the claim must be filed within two years from the date on which the tax was paid. I.R.C. § 6511(a). For purposes of claiming a refund, the payment of a tax deficiency for one year is made when the overpayment from another year is actually credited to the deficiency year. See Republic Petroleum Corporation v. United States, 613 F.2d 518, n.19 (5th Cir. 1980); Donahue v. United States, 33 Fed. Cl. 600 (1995); Bazargani v.

United States, 92-1 USTC ¶ 50,312 (E.D. Pa. 1992); Rev. Rul. 56-506, 1956-2 C.B. 959. It is undisputed that A&B did not make a timely refund claim for YEAR 1 or YEAR 2, informal or otherwise, within two years from DATE H, when the credits from YEAR 7 through YEAR 9 to YEAR 1 and YEAR 2 were authorized.

Relying upon the I.R.C. § 6601(e)(1) prescription that references to tax also refer to underpayment interest on such tax, the United States Court of Federal Claims has held that a taxpayer is required to follow the refund procedures for taxes with respect to claims for refund of deficiency interest before any suit can be filed to recover deficiency interest: “deficiency interest has been so closely braided to principal that it has been deemed an integral part of the tax.” Alexander Proudfoot Co. v. United States, 454 F.2d 1379, 1382 (Ct. Cl. 1972).

A&B argue that I.R.C. § 6402(a), by requiring the Service to refund the balance of any overpayment to a taxpayer after crediting the overpayment against any tax liabilities, mandates that the Service correct any error in the application of the overpayment to the YEAR 1 and YEAR 2 tax liabilities by allowing a refund of amounts that were allegedly “improperly applied” to the YEAR 1 and YEAR 2 from YEAR 7 through YEAR 10 based upon the original claim for refund for YEAR 7 through YEAR 10. A&B’s argument disregards the fact that the overpayments were properly applied to the tax liabilities that had been assessed, albeit in an erroneous amounts, for YEAR 1 and YEAR 2 and as advance payment for YEAR 3. As of those applications, there were no longer any overpayments in the accounts for YEAR 7 through YEAR 10 that were subject to refund.

A&B assert that they may file suit under 28 U.S.C. §§ 2401 and 2501 within six years of the date on which the overpayments were scheduled to compel the Service to issue the refunds.³ When the common law concept of “account stated” is used in tax cases, an account is “stated” when the government stipulates or agrees that a taxpayer is due a refund. Bonwit Teller & Co. v. United States, 283 U.S. 258

³ A&B further contend that they could file a mandamus action under Title 28 of the United States Code to compel the Service to pay the portion of the YEAR 7 through YEAR 10 overpayments not properly applied to A&Bs’ actual YEAR 1 and YEAR 2 deficiencies, citing Estate of Michael v. Lullo, 83 A.F.T.R. 2d ¶99-1759 (4th Cir. 1999); In Re First Federal Savings & Loan Association of Durham, 860 F.2d 135 (4th Cir. 1988); and Vishnevsky v. United States, 581 F.2d 1249 (7th Cir. 1978). As each of these case notes, a mandamus action can only be successful if the government is clearly in error and no other relief is available. A&B did have other relief available, a claim for refund, which they failed to pursue. See also Culpepper-Smith v. United States, 98-2 USTC ¶ 50,721 (E.D. Pa. 1998, and cases cited therein)(injunctions can only prevent the making of an illegal assessment, not require the refund of taxes that have been applied to a tax deficiency).

(1930). An account stated arises when: 1) the government and the taxpayer agree that the taxpayer has overpaid taxes for a given period; 2) accord has been reached as to the amount of the overpayment; and 3) the government has proposed and the taxpayer has agreed that a refund of the stated amount will be made and accepted to close the account. Junghans & Becker, *Federal Tax Litigation Civil Practice and Procedure*, 2d Ed. (1992), ¶ 18.04[1]. The taxpayer then has six years to file suit for recovery of the stated amounts that are not paid from the account.

An account stated becomes an “account settled,” however, when the government pays the amount stated to be due to the taxpayer and the taxpayer accepts the payment without objection. Atkinson v. United States, 73 F.2d 214, (8th Cir. 1934), aff’g 4 F. Supp. 398 (D. Minn. 1933); Holmes Mfg. Co., Inc. v. United States, 6 F. Supp. 438 (Ct. Cl. 1934). For comparison, see Stearns Co. v. United States, 291 U.S. 54, 66 (1933)(government’s submission of account and taxpayer’s payment of balance due without protest creates account settled); Pratt & Whitney Co. v. United States, 10 F. Supp. 148 (Ct. Cl. 1935), modifying 6 F. Supp. 574 (Ct. Cl. 1934) (suit on tax refund was barred as “account settled”). Once an account is settled, there are no grounds for recovering additional amounts from the account.

To the extent that A&B and the Service may have created an account stated when they exchanged correspondence to settle the amount of the overpayments for YEAR 7 through YEAR 10, that account became settled when the Service, with the consent and agreement of A&B, applied the overpayments as credits to the liabilities for YEAR 1 and YEAR 2 and as an advance payment for YEAR 3. A&B accepted the actions of the Service based upon several years of inaction on their part.

With your assistance, we have found several cases that favor A&B’s argument. In Close v. United States, 218 Cl. Ct. 744 Ct. Cls. 1978), the Service moved to dismiss a claim for refund of an income tax payment reported on the taxpayers’ 1976 tax year that had been credited to an assessed tax liability for 1973. Because the government stated that the unpaid 1973 tax liability had been assessed, but did not reveal the authority for the assessment or the manner in which it was made, the court held that it could dismiss the taxpayers’ claim because, based on the motion, the court was not convinced that a liability existed when the credit was made. Based upon the limited facts, the case was remanded for trial.

In Lyons v. United States, 93-1 USTC ¶ 50,026 (S.D. Iowa 1992), a district court allowed the taxpayer to pursue a claim for recovery of overpayment interest for 1979 that the Service had credited against a “disputed” liability for underpayment interest on a tax liability for 1980. Overriding the Service’s argument that the overpayment interest had been paid to the taxpayer when it was credited, the court

held that a credit against a “disputed” liability is not a payment for purposes of I.R.C. § 6611. The court relied upon the fact that the taxpayer was seeking overpayment interest, not a refund of tax or underpayment interest that would be subject to the administrative refund claim process and the shorter limitations period.

Other cases, however, support the conclusion that the taxpayer must file a timely claim for refund for the tax year in which the credit was applied. In Donahue v. United States, 33 Fed. Cl. 600 (1995), the Service credited the tax overpayment reported on the taxpayer’s 1988 return in payment of a 1985 tax deficiency. The only notice the taxpayer received that the credit had been made was a 1988 tax year refund check for less than the anticipated amount. In the two years after the credit was made, the taxpayer requested a refund for 1988 and the Service audited the 1988 return, but none of the ongoing correspondence was found to be an adequate refund claim for the 1995 tax year. Citing Close, *supra*, the United States Court of Federal Claims held:

To interpret the Tax Code as not obliging the IRS to notify a taxpayer when the IRS credits an overpayment against a prior tax year liability would not leave a taxpayer in the dark while the two-year statutory period in Section 6511(a) runs. A formal Notice of Deficiency and periodic assessment serve to place the taxpayer on notice that the IRS considers the taxpayer in arrears as to his or her income tax liability. . . [citation omitted] . . . Having received such notice, if the taxpayer later requests a refund of an overpayment for a subsequent tax year and the IRS does not provide the refund, the taxpayer reasonably should suspect that the IRS may have credited the overpayment against the taxpayer’s pre-existing tax obligation, or at the very least, the taxpayer reasonably should be expected to inquire as to the reason why the IRS did not send the requested refund.

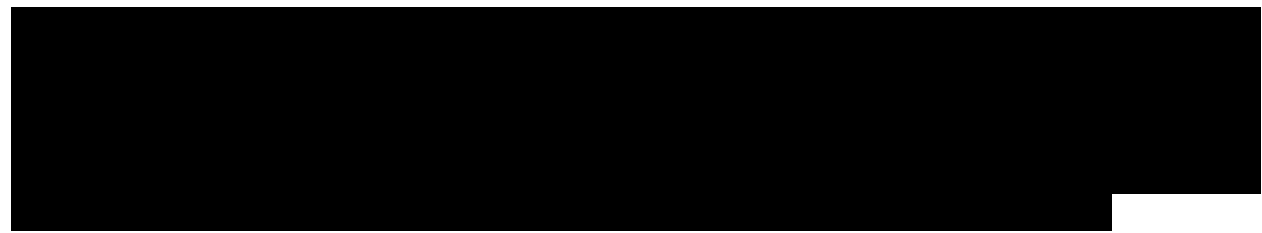
More recently, in Culpepper-Smith v. United States, 98-2 USTC ¶ 50,721 (E.D. Pa. 1998), the court dismissed a taxpayer’s suit seeking injunctive relief and a refund of overpayments credited against unpaid liabilities although the government had conceded that the assessment underlying the unpaid liabilities was illegal because no notice of deficiency had been issued. In that case, despite the government’s admitted error, the court upheld the government’s position that overpayments of tax “lost their character as overpayments” of tax when they were applied to another tax liability under section 6402 and that the only remedy was a timely refund claim for the taxes to which the overpayment was credited.

Similarly, in Tucker v. United States, 8 Cl. Ct. 575 (Cl. Ct. 1985), the court distinguished its prior ruling in Close when it held that the government could offset an unpaid income tax deficiency for another year against a refund due the taxpayer because it was clear that the taxpayer was liable for taxes for the other year. Cf.

Smith v. United States, 97-2 USTC ¶ 50,680 (E.D. Pa. 1997)(There is no valid claim for refund for a tax year if overpayment has been applied to satisfy deficiency for another tax year); Daugherty v. United States, 83-1 U.S.T.C. ¶ 9142 (Cl. Ct. 1983)(Service authorized to credit individual's overpayment from one year to another year with joint liability); United States v. Teti, 75-2 USTC ¶ 9709 (D. Conn. 1975)(Service could determine a deficiency for a tax year even if it had previously credited overpayments for that year to another tax year and could not be compelled by the taxpayer to have the credited payments returned to the first year).

Finally, we investigated the possibility that the government might reverse the crediting of the excess overpayments from YEAR 7 through YEAR 10 to YEAR 1 through YEAR 3 so as to allow A&B to have the payments refunded or credited to another tax year. In Commissioner v. Newport Industries, Inc., 121 F.2d 655, (7th Cir. 1941), the Service, after allowing a claim for refund for 1926 and crediting the overpayment against a tax liability for 1919, determined that it had erred in allowing the claim. The Service then disallowed the claim, and reversed the credit to move the funds back to the 1926 tax year, leaving a deficiency for 1919. The Seventh Circuit held that the Service had the power to correct its errors in moving funds between accounts as long as the limitations period was open, but that

Good sense commands that the correction of errors be barred after the expiration of the period of limitations relative to assessments and collections.

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2. Since a refund or credit of the petitioners' overpayments for YEAR 1 and YEAR 2 is barred by the statute of limitations, the second issue is moot as to overpayments in those years. Computation of the tax liability for YEAR 3 should take into account the portion of the YEAR 9 and YEAR 10 overpayments that were credited as advance payments to YEAR 3 after the Tax Court petition was filed.

Because any action with respect to them is barred by the limitations period on assessments and refund claims, the Service cannot take the incorrect assessment and payment of deficiency interest for YEAR 1 and YEAR 2 into account in computing deficiencies or overpayments for YEAR 3. The amounts credited to YEAR 3, however, from YEAR 9 and YEAR 10 should be treated as advance payments made by A&B after the notice of deficiency was issued. See Rev. Proc.

84-58, 1984-2 CB 501. As such, they should be taken into account in determining the amount of tax still due from A&B or the amount of any overpayment to be refunded to A&B. The deficiency to be assessed based upon the notice of deficiency is determined without regard to such payments, however. See CCDM Exhibit (35)(10)00-31 and Exhibit (35)(10)00-33, Form 33(c) for how to draft decisions covering payments of tax made after the issuance of the notice of deficiency.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:



If you have any further questions, please call (202) 622-7940.