INTERNAL REVENUE SERVICE

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MEMORANDUM FOR ASSOCIATE DISTRICT COUNSEL
ROCKY MOUNTAIN DISTRICT

FROM: Joseph W. Clark
Acting Deputy Assistant Chief Counsel
(General Litigation)

SUBJECT: Significant Service Center Advice: Offsets to Satisfy Erroneous Refunds in Absence of Assessment or Judgement

This responds to your request for Significant Service Center advice, in connection with questions posed by the Ogden Service Center.

ISSUES

1. Can the Internal Revenue Service recover a nonrebate erroneous refund pursuant to its common-law right of offset.

2. If so, what is the applicable statute of limitations?

CONCLUSIONS

1. Yes. The Service may recover a nonrebate erroneous refund pursuant to the long established principle of offsetting mutual debts between mutual parties.

2. The applicable statute of limitations to recover a nonrebate erroneous refund is the two or the five year period set forth in I.R.C. § 6532(b).

FACTS

The Ogden Service Center has requested your assistance in reviewing a number of erroneous refund cases under Internal Revenue Manual 3.17.79.16.5.1.[1] In the process

[1] IRM 3.17.79.16.5.1 requires the Service to coordinate with district counsel all cases where it appears that any part the erroneous refund "was induced by fraud of misrepresentation of a material fact." I.R.C. § 6532(b).

of reviewing these cases to determine whether the five year period of limitations applies, your office became aware that the majority of these refunds were being recouped under the common-law right of offset. You believe that the Service may not offset overpayments otherwise due to the taxpayer with respect to other tax years against an erroneous refund liability unless the Service either makes a new assessment or obtains a judgment for the erroneous refund. While we agree with you that the Service may not rely on Internal Revenue Code section 6402 to offset overpayments against unassessed erroneous refund liability, we are of the opinion that the Service may recoup nonrebate erroneous refunds under the common-law right of offset.

LAW & ANALYSIS

Erroneous refunds fall into one of two general categories. The first category consists of refunds which are "rebates" within the meaning of I.R.C. § 6211(b)(2).[2] Rebate refunds occur when the Service reduces or abates the taxpayer's liability on the basis that the correct tax liability is less than the amount previously assessed or reported by the taxpayer on the return. See Singleton v. United States, 128 F.3d 833, 836 n.11 (4th Cir. 1997); Clayton v. Commissioner, T.C. Memo 1997-327. The propriety of a rebate refund, therefore, depends on the correctness of the assessed tax. Id.

To recover a rebate erroneous refund, a new determination of the taxpayer's tax liability, either administrative or judicial, must take place. If an administrative approach is taken, the Service will generally have to follow deficiency procedures[3] and make a new or supplemental assessment within the applicable assessment period. I.R.C. §§ 6204, 6211 *et seq.*, and 6501. Once a new assessment is made, the Service will have 10 years from the date of the assessment to collect the tax. I.R.C. § 6502. Alternatively, the Service may bring either a suit to reduce the liability to judgment (brought within the assessment period) or an erroneous refund suit pursuant to section 7405 of the Internal Revenue Code (brought within the period of limitations set forth in section 6532(b)).

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[2] Certain erroneous refunds, while not "rebates" within the meaning of section 6211(b)(2), are, nonetheless, assessable under the Code. E.g., I.R.C. § 6201(a)(3). Once the amount refunded is assessed, it can be collected in the same manner as a tax within the 10-year collection period.

[3] Assessment of certain erroneous income tax prepayment credits (Category B refunds) made under the authority of I.R.C. § 6201(a)(3) is not subject to the deficiency procedures. Certain nondeficiency taxes would, likewise, not be subject to the restrictions placed on deficiencies. I.R.C. § 6211 et seq.

The second category of erroneous refunds consists of refunds which are not considered "rebates" within the meaning of section 6211(b)(2). See Lesinski v. Commissioner, T.C. Memo 1997-234; Groetzinger v. Commissioner, 69 T.C. 309, 315 (1977). Because these erroneous refunds are not rebates, they are often referred to as "nonrebate erroneous refunds." Nonrebate erroneous refunds occur not as a result of a redetermination of the taxpayer's liability but rather as a result of an error committed in performing some function other than recomputing the tax liability, i.e., misapplied payment, misdirected direct deposit, duplicate refund. O'Bryant v. United States, 49 F.3d 340, 342 (7th Cir. 1995); Clayton, supra. As such, these refunds generally do not affect the taxpayer's tax liability and cannot be assessed under the Internal Revenue Code.

Because nonrebate erroneous refunds cannot be assessed in the same manner as rebate refunds, the remedies generally available to the Service to collect unpaid tax liabilities are not available to the Service to recover nonrebate erroneous refunds. The Service, however, has other remedies to recover amounts erroneously refunded out of the treasury. First, the Service may recover any erroneous refund by instituting an erroneous refund suit in accordance with I.R.C. § 7405. Stanley v. United States, 140 F.3d 1023 (Fed. Cir. 1998). In order to be timely, an erroneous refund suit must be filed within two (or five) years from the date the taxpayer received the erroneous refund. O'Gilvie v. United States, 519 U.S. 79 (1996); I.R.C. § 6532(b). The Service may solicit a voluntary repayment of the erroneous refund within two or five years from issuance of the erroneous refund. I.R.C. § 6532(b). Stanley, 140 F.3d at 1028 (Service has long used consensual dispute resolution in lieu of litigation). These, however, are not the only remedies the Service may use to recover a nonrebate erroneous refund. See Brookhurst v. United States, 931 F.2d 554, 556-57 (9th Cir. 1991) (government may use methods other than specific erroneous refund suit provision to recover erroneous refund). Accord O'Bryant, 49 F.3d at 343 n.4; Crocker First Nat'l Bank v. United States, 137 F. Supp. 573 (N.D. Cal. 1955).

The general authority to apply overpayments against outstanding tax liabilities can be found in I.R.C. § 6402(a). This section provides in relevant part as follows:

> In case of an overpayment, the Secretary, within the applicable period of limitations, may credit the amount of such overpayment ... against any liability in respect of an internal revenue tax on the part of the person who made the overpayment....

I.R.C. § 6402(a). While the phrase "any liability in respect of an internal revenue tax" is not defined in the statute, it has long been the Service's position that a tax liability, which could be enforced through normal assessment and collection procedures

(i.e. a tax liability which has been assessed or for which a statutory notice of deficiency has been issued), is a prerequisite to making an offset under section 6402. See Treas. Reg. § 301.6402-1. Accordingly, unless the Service can assess the amount erroneously refunded (as in a case of a rebate refund), the Service may not use its statutory right of offset under I.R.C. § 6402 to recover the erroneous refund.

Section 6402(a), nonetheless, does not preclude an offset of an overpayment against a non-tax debt as long as an independent authority exists for the offset.[4] Isbrandtsen Co. v. Johnson, 343 U.S. 779, 783 (1952) ("statutes which invade the common law... are to be read with a presumption favoring the retention of long established and familiar principles, except when statutory purpose to the contrary is evident"). It is a long established principle that the Government has the same common law right belonging to every creditor to set off monies owed by it to debts due it by the same debtor. United States v. Munsey Trust Co., 332 U.S. 234 (1947); Cherry Cotton Mills, Inc. v. United States, 325 U.S. 234 (1947); Crocker, supra. Additionally, the right to set off against non-tax debts due the Government has been expressly provided for by statute. See, e.g., 31 U.S.C. § 3711 (1999). Because liability resulting from a nonrebate erroneous refund is not a tax liability, see O'Bryant, supra, the statutory framework which governs collection of taxes is not frustrated by the use of common-law right of offset to recover this type of refund. See Chateaugay Corp. v. LTD Steel Co., 94 F.3d 772, 778-79 (2d Cir. 1996) and the cases cited therein.

While the most recent decision in this area contains language adverse to the Government, see Moran v. United States, 953 F. Supp. 354, 357 (N.D. Okl. 1996)[5], we are of the opinion that the Service should continue to assert its rights under the common law. See Chateaugay, 94 F.3d at 778 ("there is no better proof of the existence of a common law right than its exercise, and acceptance by the courts"). We agree with the approach taken by the court in Crocker, supra. In that case, the Service erroneously refunded to the taxpayer interest on his refund for the 1942 tax year. A year later, the Service requested repayment of the erroneous interest. The taxpayer did not repay it. Subsequently, in 1948, the taxpayer filed a return for the year 1945 seeking a refund. The Service allowed the taxpayer's claim but offset part of the 1945 overpayment against the 1942 erroneous refund liability.

Because the offset was accomplished more than two years after the erroneous interest payment was made to the taxpayer, the court ruled for the taxpayer. In relevant part,

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[4] See O'Bryant v. United States, 49 F.3d 340, 345 (7th Cir. 1995) (there is a fundamental difference between a tax liability and a nonrebate erroneous refund).

[5] Please note that in Moran the Service did not offset a tax overpayment against an erroneous refund liability but rather attempted to collect, via levy, an erroneous refund in reliance on the original, but previously paid, assessment. As such, the case is inapposite to the situation at hand.

however, the court noted:

> While the plaintiff does not concede that the payment by the Government of interest on the refund of 1942 taxes was in fact erroneous, it has chosen to rest its case on the contention that the offset in 1950 was not timely made. There is no limitations statute specifically fixing the time within which such offset may be made. There is, however, a statute, limiting to two years, the time within which the United States may sue to recover erroneous refund of taxes or erroneous payments of interest on refund. Since it is obvious that the offset claimed by the Commissioner must be the equivalent of a cause of action by the Government in a suit to recover the erroneous payment ... the time limitation for suit applies equally to the offset.

Crocker, 137 F. Supp at 574 (*citations omitted*).

In conclusion, we are of the opinion that as long as the Service is unable to assess nonrebate refunds, the Service may justifiably rely on the common law right of offset to recover these non-tax debts. The applicable statute of limitations for this remedy is the two or five year period set forth in I.R.C. § 6532(b). Although the taxpayer may voluntarily and knowingly waive this period, see United States v. National Steel Corp., 75 F.3d 1146 (7th Cir. 1996), the Service should not solicit such waivers for the sole purpose of offsetting the taxpayer's refunds to the erroneous refund liability. Waivers should be requested only in limited circumstances, such as where a taxpayer agrees to repay the erroneous refund but needs additional time. These waivers, however, should be short and have a specific end date (i.e. no open-ended extensions).

If you have further questions, please contact the attorney assigned to this matter at 202/622-3620.

cc: All Assistant Regional Counsel (General Litigation)