

Office of Chief Counsel  
Internal Revenue Service  
**Memorandum**

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date: July 27, 2004

to: Associate Area Counsel (Salt Lake City)  
(Small Business/Self-Employed)  
CC:SB:5:SLC

from: Blaise G. Dusenberry  
Special Counsel, Administrative Provisions & Judicial Practice  
(Procedure & Administration)  
CC:PA:APJP

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subject: Foreign Earned Income -- Military

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

This responds to your request for review of a draft service center advice dated May 5, 2004.

You have described a situation in which certain taxpayers report that they have worked as employees of the United States military in foreign countries and claim a foreign earned income exclusion on Form 2555 (Foreign Earned Income). In the examples provided, the taxpayers have attached copies of military orders either directing them to report to an assignment in a foreign country or directing them to return from an assignment to a foreign country. By claiming the foreign earned income exemption, these taxpayers eliminate all tax from their returns and claim a full refund of all withholding. Although not clear from the facts presented, it is our understanding that these exemptions were being claimed because of improper advice given by certain tax professionals.

For your convenience, our discussion addresses the issues analyzed in your memorandum.

### Application of I.R.C. § 6702

At this time, we think it is not appropriate to impose a section 6702 frivolous return penalty in these cases. As noted above, it appears that the income exclusion is currently being claimed based on the improper advice of persons holding themselves as knowledgeable in this area. While the return in question raises strong suspicion that it is frivolous, assertion of the penalty against active duty service persons is not in the Service's interest at this time.

### Application of I.R.C. § 6501(c)

As a general matter, we do not recommend relying on an unlimited statute of limitations in these cases. Section 6501(c)(1) allows the Service to assess tax at any time in the case of either a "false or fraudulent return with the intent to evade tax." Section 6501(c)(2) does not apply to income tax returns and, therefore, does not appear to apply in this situation. Although the majority of the fraud cases deal with either failure to report income or failure to file returns, a return can also be fraudulent if deductions are overstated. See, e.g., Neaderland v. Commissioner, 52 T.C. 532 (1969), aff'd, 424 F.2d 639 (2d Cir. 1970) (underpayment of taxes resulting from the taxpayer's overstatement of business deductions was due to fraud); Toussaint v. Commissioner, 743 F.2d 309 (5<sup>th</sup> Cir. 1984), aff'g T.C. Memo. 1984-25 (theft loss deduction for nonexistent Picasso painting was due to fraud).

Fraud should not be asserted, however, where the taxpayer did not intend to deceive. See Raley v. Commissioner, 676 F.2d 980 (3d Cir. 1982) (where taxpayer told everyone involved in the collection process that he was not going to pay his taxes, court found there was no attempt at deceit); Muste v. Commissioner, 35 T.C. 913 (1961) (taxpayer who informed IRS each year of refusal to pay taxes was not liable for fraud penalty). Fraud requires a determination that a taxpayer intended to evade tax and "is never imputed or presumed." Toussaint, 743 F.2d at 312.

In these cases, the taxpayers are claiming the foreign earned income exclusion on the Form 2555 attached to their returns. The returns may be filed in reliance on incorrect information from purported tax advisors. Where the taxpayer relied on incorrect advice, the taxpayer may not possess a fraudulent intent. Thus, we believe it is not appropriate to assert either a fraud addition or fraudulent intent sufficient to sustain application of the extended period of limitations under I.R.C. § 6501(c)(1). We simply do not have enough information, based on the facts stated. Further development of the case may lead to information suggestive of fraud, and in such cases we agree that application of the extended period is appropriate.

Additional concerns make us unwilling to endorse application of the I.R.C. § 6501(c)(1) period of limitations. It is true there is no legal requirement to assert the fraud addition for the Service to rely on I.R.C. § 6501(c)(1). Determining the addition, however, serves

to put the taxpayer on notice that the unlimited period is being asserted. We are also concerned that if these cases go forward on an extended statute basis, insufficient case development may hamper their successful litigation in the long run. We assume that a taxpayer confronted with what appears to be a late statutory notice will petition the Tax Court. In the Tax Court, the Service will have to demonstrate the fraudulent nature of taxpayer's conduct. The Service may lack enough information, or may be forced to perform extensive case development while the case is pending. We are concerned the Service may not succeed in case development and will be forced to concede most of these cases. Thus we strongly recommend against routinely relying on the I.R.C. § 6501(c)(1) period.

#### Validity of the Return and Whether It Is Processible

Generally, we believe that the advice provides an adequate response. However, we note that in the discussion regarding I.R.C. § 6611(g), the advice states that a return is not processible until four criteria are met. The advice inaccurately states that one of the statutory criteria (item 4) is that "the taxpayer submits, in good faith, sufficient required information (whether on the return or on required attachments) to permit the mathematical verification of the tax liability shown on the return." This statement is mostly a verbatim recitation of section 6611(g)(2)(B)(ii); however, the statute does not explicitly provide for a "good faith" requirement. The "good faith" requirement is a condition that generally has been read into the Code by the Courts. See, e.g., The Columbia Gas System, Inc., v. United States 70 F.3d 1244, 1246 (Fed. Cir. 1995). Accordingly, we recommend that the discussion regarding section 6611(g) be revised by quoting the statutory language verbatim and removing the reference to the "good faith" requirement.

Nevertheless, we agree with the conclusion that the IRS should treat these returns as processible, since the returns meet all of the statutory criteria under section 6611(g). We also agree that the IRS might be able to make an argument that the taxpayers did not submit the returns in good faith, relying on the cited cases, but that the question of good faith should be considered in the context of determining the validity of the return rather than whether the return is processible.

A draft revised discussion is attached to this memorandum.

For questions relating to this issue, please contact

CC:PA:APJP:Br1, (202) 622-4910.

#### Recovery of an Erroneous Refund and Collection Actions

Issue 4 (addressing erroneous refunds), as currently drafted, to some extent confuses three separate concepts: (1) the immediate action to prevent the payment of – or, if payment has already been made, to recover (without a formal determination of liability) – a refund induced by a false or fraudulent refund claim; (2) the determination of a liability, whether by deficiency, in an erroneous refund action, or in another court action;

and (3) the collection of such a determined liability. The second of these, determining a liability (if immediate recovery proves unavailing), is best dealt with as issue 4, while issue 6 (addressing collection actions) is the proper place to address recovery before a determination of liability, as well as collection after a determination of liability.

A draft revised discussion of these issues is attached to this memorandum.

Please contact CC:PA:CBS:Br3, at (202) 622-3630 for questions related to these issues.

### Referral of the Return Preparer for Investigation

The I.R.C. § 6694 penalty may apply if: (1) the position that results in an understatement of liability does not have at least a “realistic possibility” – i.e., a one-in-three – chance of success; or (2) the position that results in an understatement of liability is frivolous or is not disclosed. I.R.C. § 6694(a). The penalty under I.R.C. § 6694 is \$250 for each return or claim for refund that meets either of these two requirements. Id. There is a reasonable cause exception for this penalty. Id. The position that income earned by U.S. uniformed military personnel qualifies for the foreign earned income exclusion is one that is not supported by a realistic possibility of success. U.S. military personnel are not entitled to exclude their income under I.R.C. § 911. I.R.C. § 911(b)(1)(B); Treas. Reg. § 1.911-3(c)(3). The instructions to the Form 2555 clearly state, “If your only earned income from work abroad is pay you received from the U.S. Government as its employee, you do not qualify for either of the exclusions or the housing deduction. Do not file Form 2555.”

“Disclosure” in this context has the meaning given by I.R.C. § 6662(d)(2)(B)(ii), which requires adequate disclosure either in the return or in a statement attached to the return. Regulations provide that disclosure is adequate if either made on a properly completed Form 8275 (Disclosure Statement) (or on a Form 8275-R (Regulation Disclosure Statement) if the position is contrary to a regulation). Disclosure made on the return (or claim for refund) without the Form 8275 or 8275-R may also be adequate if it is in accordance with Rev. Proc. 2002-66, 2002-2 C.B. 724. That revenue procedure states that the following amounts shown on a Form 1040 may constitute adequate disclosure for purposes of I.R.C. §§ 6662 and 6694: (1) certain itemized deductions; (2) certain trade or business expenses; (3) certain amounts reflected on a Schedule M-1 (Reconciliation of Income (Loss) per Books with Income per Return); and (4) certain other expenses.

The exclusion of income under I.R.C. § 911 is not mentioned in Rev. Proc. 2002-66. It does not appear from the facts presented the position that the foreign earned income exclusion applies is being disclosed on a Form 8275 attached to the returns. Therefore, even if it is shown that the position is not frivolous, it is not being adequately disclosed within the meaning of I.R.C. § 6694. Therefore, it may be appropriate to assert a I.R.C. § 6694 preparer penalty in these cases. We understand that one preparer in particular

may be responsible for these returns; we urge you to refer the preparer of all these returns to the LDC as soon as possible.

Section 6700, in relevant part, imposes a penalty equal to the lesser of \$1,000 or 100 percent of gross income derived from the activity on any person who organizes (or assists in the organization of) any plan or arrangement (or participates in the sale of an interest therein) and, in connection with the organization or sale, makes a statement concerning the allowability of a deduction, or excludability of income which the person knows to be false or fraudulent as to any material matter. I.R.C. § 6700(a).

Section 6701, in relevant part, imposes a penalty on any person who gives advice to a taxpayer related to the preparation of any portion of a return, claim, or other document, if that person knows (1) that the portion will be used in connection with a material matter arising under the internal revenue laws; and (2) that the portion (if so used) would result in an understatement of tax liability of the taxpayer. I.R.C. § 6701(a). The penalty under I.R.C. § 6701 is generally \$1,000 per taxpayer. I.R.C. § 6701(b).

No penalty can be assessed under I.R.C. § 6694 with respect to any document for which a penalty is assessed under I.R.C. § 6701(a). I.R.C. § 6701(f)(2). No penalty can be assessed under I.R.C. § 6700 with respect to any document for which a penalty is assessed under I.R.C. § 6701(a). I.R.C. § 6701(f)(3).

An injunction under I.R.C. § 7407 may be sought in appropriate circumstances to prevent the recurrence of conduct subject to penalty under I.R.C. § 6694, and an injunction under I.R.C. § 7408 may be sought in appropriate circumstances to prevent the recurrence of conduct subject to penalty under I.R.C. § 6700 or § 6701.

We are advised by our contacts in CC:INTL that the source of these returns is one particular return preparer. It appears that this individual may be preying on vulnerable military service persons and/or their dependents. In light of the potential abuse, and the fact that the Pentagon is extremely concerned about this matter, we urge you to refer any preparer of a return of this kind to the LDC for potential I.R.C. §§ 6700 and 6701 violations. We think injunctive action may have a beneficial enforcement effect, and would allay concerns that the Service appears to be penalizing the victim while the real violator is not pursued.

Please contact  
questions.

CC:PA:APJP:Br2, (202) 622-4940 if you have any

### **ATTACHMENTS**

#### **Is the Return Valid and Processible?**

The determination of whether a return qualifies as processible depends on the criteria set forth in I.R.C. § 6611, regarding interest on overpayments. Section 6611(a) generally provides that interest shall be allowed and paid upon any overpayment in

respect of any internal revenue tax. Section 6611(b)(3) and (e) generally require that a return be filed before a taxpayer is eligible to receive interest on an overpayment.

Section 6611(g)(1) provides that for purposes of section 6611(b)(3) and (e), a return shall not be treated as filed until it is filed in processible form.

Section 6611(g)(2) provides that for purposes of section 6611(g)(1), a return is in a processible form if (A) such return is filed on a permitted form, and (B) such return contains (i) the taxpayer's name, address, and identifying number and the required signature, and (ii) sufficient required information (whether on the return or on required attachments) to permit the mathematical verification of tax liability shown on the return.

The documents submitted for our review would meet all of the statutory requirements for processing. However, in addition to the statutory requirements recited above, the Courts have also generally required that the returns be filed by the taxpayer "in good faith." For example, in The Columbia Gas System, Inc. v. United States, 70 F.3d 1244, 1246 (Fed. Cir. 1995), the Court of Appeals for the Federal Circuit stated that:

Mathematical verifiability requires sufficient information to permit IRS to recalculate and corroborate the mathematics and data reported by the taxpayer. Thus, under section 6611, a taxpayer must submit, in good faith, all the required forms with the required signatures and enough underlying data for the IRS to verify the tax liability shown on the return. The information must be sufficient to enable IRS to calculate the tax liability without undue burden.

In this case, the taxpayers have arguably not followed the instructions for the forms, and they have *improperly excluded from income the settlement proceeds obtained through discrimination litigation*. While the IRS might have a valid argument that the taxpayers did not submit the returns in good faith, we recommend that the IRS treat the returns in question as processible. However, the IRS may still raise the issue of good faith in the context of determining the validity of the return.

In this context, the courts have identified four key criteria for evaluating the validity of a return. These four criteria are as follows:

- 1) There must be sufficient data to calculate tax liability;
- 2) The document must purport to be a return;
- 3) There must be an honest and reasonable attempt to satisfy the requirements of the tax law; and
- 4) The taxpayer must execute the return under penalties of perjury.

Beard v. Commissioner, 82 T.C. 766, 777 (1984), aff'd per curiam, 793 F.2d 139 (6<sup>th</sup> Cir. 1986). These four criteria are generally known as the Beard formulation or the “substantial compliance” standard, which is derived from a line of Supreme Court cases, including Zellerbach Paper Co. v. Helvering, 293 U.S. 172 (1934), and Florsheim Bros. Drygoods Co. v. United States, 280 U.S. 453 (1930). These cases hold that if a return meets the “substantial compliance” standard, the return is a valid return for purposes of the statute of limitations on assessment. This determination is based on the facts and circumstances of each case. Accordingly, no “bright line” test exists to determine whether a taxpayer has filed a valid return.

Because the taxpayers in this case have failed to follow the form instructions when completing their returns, the IRS might be able to argue that these taxpayers did not make an honest and reasonable attempt to comply with the tax law. We do not, however, believe it would be prudent to make such an argument in this case. Instead, we believe that the IRS should process the returns, and deny the claims for refund as part of a deficiency determination.

## **ISSUES RELATING TO ERRONEOUS REFUNDS AND COLLECTION**

### **Issues**

1. What process should the IRS follow to determine a liability (e.g., deficiency or other, including by a court) to recover erroneous refunds?
2. Would the IRS need to use the notice of deficiency procedures, and if so, how should the IRS treat the deletion of income found in the amended return?
3. If the IRS has made an erroneous refund (whether by credit, electronic funds transfer or mailed check), what actions may the IRS take to protect the revenues from immediate harm, to recover a refund as misappropriated government property, or to collect a determined liability?

### **Conclusions**

1. There are two methods for determining a liability under the facts presented. One is to follow the deficiency procedures. The other is to follow the erroneous refund suit procedures of I.R.C. § 7405. Because of the greater efficiency which the notice of deficiency procedures provide, we recommend that the IRS use those procedures. The general period of limitations is three years from the date the original return is filed. To secure a determination of liability through erroneous refund litigation, the erroneous refund suit must normally be brought within two years of the refund, but where the taxpayer induced the making of the erroneous refund by fraud or misrepresentation of material fact, the government must bring an action under IRC § 7405 within the five-year period of I.R.C. § 6532(b).

2. We recommend the use of a notice of deficiency if the IRS has issued an erroneous refund. The IRS should disallow the claimed deduction for foreign earned income exclusion.

3. Before a liability is determined, and before the erroneous refund is received or before it becomes a final payment, the IRS can always, subject to applicable time limits: (a) cause Financial Management Services (FMS) to stop issuance of an EFT or check; (b) cause the United States Postal Service (USPS) to prevent delivery and return a mailed check; and (c) cause a Stop Payment of an EFT or check. The IRS can also request voluntary repayment of an erroneous refund. Once the refund becomes a final payment, the deficiency procedures or the erroneous refund suit procedures may be used to determine liability. However arrived at, after a liability is determined, the IRS has administrative procedures for assessment and collection if the liability is a deficiency, and the government has judgment collection procedures if the liability (whether deficiency or erroneous refund) is reduced to judgment.

## **Discussion**

### **Recovery of an erroneous refund**

#### **Recovery Before Determination of a Collectible Liability**

Without establishing any reason at all for recovery, the IRS as the authorizer or issuer of a payment can recover in the following ways.

One way is to cancel payment. If the IRS discovers that it erroneously issued a voucher to Financial Management Services (FMS) directing FMS to issue a payment (whether by EFT or check), the IRS within a very short period of time after issuing the payment voucher can cause (such as by issuing a voucher canceling the payment voucher) FMS to stop issuance of the EFT or check before it leaves the FMS facility. We have been advised by FMS that their processing time for a check is ten days and their processing time for an EFT is three days, both measured from the date that FMS receives the electronic voucher from the IRS. If the payment is successfully stopped, FMS re-credits the amount back to the IRS.

Another way is to request a Mail Stop. If an erroneous refund is discovered after the refund check is put in the hands of USPS, the IRS can submit an expedited request to any USPS post office identifying the mail-piece and the Treasury Department (IRS) as the sender. This procedure is provided in USPS Domestic Mail Manual (Issue 56 plus Postal Bulletin changes through PB22047, 4-5-01) D030 1.2, which states: “[a] federal agency may recall any mail-piece sent as official mail by submitting to any post office a Mailgram or an Express Mail letter identifying the piece.” The USPS treats the IRS as the sender of all IRS refund checks.



The USPS inputs the information into its computer system to notify processing and receiving postal facilities, which will conduct searches for the mail item. If the USPS is able to locate the mail item in its hands before delivery, the mail item will be returned to the IRS. The IRS processes a returned check as a voided check, the paper check is returned to FMS, and FMS re-credits the amount back to the IRS.

Another way is to issue a Stop Payment order. During the period before the erroneous refund is considered made (as a final payment, whether in regard to an EFT or check), the IRS or FMS can issue a Stop Payment on the EFT or check. The Stop Payment can be issued to a specific bank or to a small group of banks at any time during the period before completion of the Treasury first review, the time at which a payment becomes final. United States v. Commonwealth Energy System & Sub Cos., 235 F.3d 11 (1st Cir. 2000).

If it is too late for any of these loss-prevention measures, the IRS may attempt to recover the erroneous refund without a liability determination but with assertion of grounds for recovery by requesting voluntary repayment. If the refund is in the hands of the taxpayer, the IRS can contact the taxpayer and ask for voluntary repayment of the erroneous refund and the filing of an amended return. The communication from the IRS should explain the reason why the claim of the credit is not allowable.

#### Recovery Through Determination of a Collectible Liability

To determine a collectible liability without use of expedited procedures,<sup>1/</sup> you will need to use the audit and statutory notice procedure or the erroneous refund suit procedure. Again, we recommend the notice of deficiency procedure as the IRS can then use its administrative collection tools to collect the amount assessed either because of default by the taxpayer or after a determination by the Tax Court. Collection of such a determined liability can be administrative or judicial.

Regarding the statute of limitations, normally the IRS has only three years from the filing of a return in which to issue a notice of deficiency. See I.R.C. § 6501(a). For erroneous refunds, the IRS could initiate an erroneous refund suit pursuant to I.R.C. § 7405 within the two-year period of I.R.C. § 6532(b) running from the making of the erroneous refund. However, for recovery of erroneous refunds the making of which was induced by fraud or misrepresentation of material fact, the IRS can rely on the five-year period of I.R.C. § 6532(b) running from the making of the erroneous refund.

The IRS receives more time to deal with erroneous refunds the making of which were induced by fraud or misrepresentation of material fact. For example, the

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<sup>1/</sup> Upon finding that the jeopardy standards are met, the IRS can immediately assess and collect a deficiency without regard to the normally applicable administrative deficiency procedures and levy procedures. These expedited procedures require that a deficiency notice be subsequently issued, and CDP rights are provided following the jeopardy collection.

requirement of proving such fraud or misrepresentation is satisfied in the case of a return that falls within Rev. Rul. 2004-28. The period runs from the making of the erroneous refund, which is defined as the completion of the Treasury Department's first review. See United States v. Commonwealth Energy System & Sub Cos, 235 F.3d 11 (1st Cir. 2000) (erroneous refund suit period runs from date check clears Treasury first review).

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Please call 202 622-4940 if you have any further questions.