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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE
SIGNIFICANT SERVICE CENTER ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL (SMALL BUSINESS/SELF-EMPLOYED) CC:SB:1:BOS

FROM: Robert A. Miller
Senior Technician Reviewer, Branch 3 (Collection, Bankruptcy & Summonses) CC:PA:CBS:B03

SUBJECT: Misidentified Tax Deposits

This Significant Service Center Advice responds to your undated memorandum received on August 23, 2002, requesting this advice. In accordance with I.R.C. § 6110(k)(3), this Significant Service Center Advice should not be cited as precedent.

ISSUES

1. Under the "fraud or misrepresentation" exception in I.R.C. § 6532(b), which extends the statute of limitation for erroneous refund suits from two years to five years in cases of fraud or misrepresentation, may the United States pursue erroneous refund claims more than two years old against an employer whose deposits of withheld income tax did not comply with the rules for deposits causing the payments to be applied to the accounts of, and ultimately refunded to, individual employees?

2. Alternatively, may the IRS refuse to credit the deposits to the employer's account and assess unpaid taxes against the employer?

CONCLUSIONS

1. Regardless of the applicability of the “fraud or misrepresentation” exception, the United States may not bring an erroneous refund suit against the employer because the employer did not receive the erroneous refunds. The United States may, however, bring an erroneous suit against an employee or former employee who received the refund, any time within the statute of limitation. The United States is entitled to the five-year limitations period because the employer’s actions, which caused the erroneous refunds, constitute misrepresentation for purposes of the “fraud or misrepresentation” exception.

2. As an alternative to erroneous refund actions, the IRS may treat the deposits as payments of the employees’ income tax liabilities and refuse to credit the payments to the employer’s account. The employer is liable for its unpaid taxes, and the IRS may assess the taxes against the employer.

FACTS[1]

A corporate employer remitted payments to the IRS of withheld income taxes in the form of checks made payable to the IRS or the United States Treasury, with the name and SSN of an individual employee or former employee on each check’s memo line. The income taxes were withheld from remuneration other than wages, e.g., pension or retirement plan distributions. The checks did not include the employer’s EIN. In some instances the checks were accompanied by a letter from the employer, which at most indicated that the checks were tax payments on distributions to the employees or former employees but did not indicate the checks were deposits of withheld taxes or the type of taxes being paid. The letters also did not include the employer’s EIN. The employer filed an untimely Form 945, Annual Return of Withheld Federal Income Tax, for the tax year in question. Before the return was filed, the IRS erroneously credited the amounts of the deposits to the individual employees’ or former employees’ IMF accounts. The individuals received from the employer Forms 1099-R, Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, Etc., showing the amounts paid to the IRS. The individuals then filed income tax returns on which he or she claimed the amount on the Form 1099-R as paid income tax. For each individual, the IRS credited a second time this amount to his or her account and refunded the money to the individual as an overpayment. After the refunds were made, the employer filed the Form 945, showing the deposits as taxes paid. When the IRS discovered the refunds were made in error, the two-year statute of limitation for refund claims set forth in I.R.C. § 6532(b) had expired, though the five-year statute of limitation, for cases of fraud or misrepresentation, has not.

[1] The facts are intended to be generic and non-taxpayer-specific.

LAW AND ANALYSIS

Tax Deposit Rules

To answer both issues it is necessary to first explain the rules governing federal tax withholding and deposits. I.R.C. § 3405 requires an employer to withhold and pay over FICA, Medicare, and income taxes from distributions under deferred compensation plans, such as pension, annuity, and profit-sharing plans; IRAs; and commercial annuities. An employer is liable for the taxes required to be withheld and paid. I.R.C. § 3405(d)(1). These taxes must be deposited in the same manner as taxes withheld from wages (payroll taxes). I.R.C. § 3405(f); Treas. Reg. § 31.6302-4(a). If, however, the withheld taxes are less than $2,500 for the year ($1,000 for years prior to 2001), no deposits are required, and the taxes may be paid when the Form 945 is filed.

Depending on prior amounts, an employer is either a semi-weekly depositor or a monthly depositor. Treas. Reg. § 31.6302-4(c)(2). If the employer is a monthly depositor, the withheld nonpayroll taxes accumulated in a given month must be deposited on the fifteenth day (or next business day, if the fifteenth day falls on a weekend or is a holiday) of the next month. Treas. Reg. § 31.6302-1(c)(1). If the employer is a semi-weekly depositor, then the employer must generally make a deposit within three business days after the taxes are withheld. I.R.C. § 31.6302-1(c)(2). More specifically, any taxes withheld from Saturday through Tuesday must be deposited by the next Friday, while any taxes withheld from Wednesday through Friday must be deposited by the next Wednesday.

The taxes must be deposited electronically using the Electronic Federal Tax Payment System (EFTPS) if a certain threshold is met, otherwise using Form 8109, Federal Tax Deposit Coupon, which along with the payment is deposited in a Federal Reserve bank or other financial institution authorized to accept federal tax deposits. As an alternative for non-EFTPS depositors, the coupon and payment may be mailed to the Financial Agent, Federal Tax Deposit Processing, in St. Louis. An employer using coupons should use those that are preprinted with the employer's EIN; the preprinted coupons are sent to the employer by the IRS. If an employer does not have preprinted coupons, the employer should use Form 8109-B, on which the employer must provide its EIN. The payment accompanying the coupon may be cash or a check or money order. Checks and money orders must be made payable to the bank or other financial institution accepting the deposit. Coupons may only be sent to the IRS, and checks may only be made payable to the United States Treasury, if the employer does not have an EIN. In that case, the check must show not only the employer's name and address but also the type of tax, the period covered, and the date the employer applied for an EIN. In addition, an explanation of the payment must be sent with the deposit.

Erroneous Refund Actions

I.R.C. § 7405 authorizes the United States to bring a civil action for the recovery of an erroneous refund. In such an action, the taxpayer who was received the erroneous refund is the real party in interest. 35A Am. Jur. 2d, Federal Tax Enforcement § 1183 (2002) (citing Rushlight Automatic Sprinkler Co. v. United States, 294 F.2d 572 (9th Cir. 1961)). In the instant scenario, the erroneous refunds were paid to the individual taxpayers, not to the employer. Therefore, regardless of which statute of limitation applies, the United States may not bring an action under section 7405 against the employer. Erroneous refund actions may be brought against the individual taxpayers if the United States is entitled to the five-year limitations period.

The five-year period applies if the refund was "induced by fraud or misrepresentation of a material fact." I.R.C. § 6532(b). For purposes of section 6532(b), "fraud" requires an intentional or knowing deception or misrepresentation that induced the erroneous refund. Lane v. United States, 286 F.3d 723, 731 (4th Cir. 2002). In the example described above, there is no indication of fraud.

To prove a misrepresentation of material fact, the United States must prove three elements: (1) that a misrepresentation of fact was made; (2) that the fact was material; and (3) that the misrepresentation induced the erroneous refund. United States v. Indianapolis Athletic Club, Inc., 785 F. Supp. 1336, 1337-38 (S.D. Ind. 1991). Unlike fraud, a misrepresentation of material fact does not require intentional or knowing conduct, and gross negligence, but not ordinary negligence, qualifies. Lane v. United States, 286 F.3d 723, 732 (4th Cir. 2002) ("[T]he United States need not demonstrate more than gross negligence in order to avail itself of § 6532(b)'s five-year limitations period."); see also Black Prince Distillery, Inc. v. United States, 586 F. Supp. 1169, 1174 (D.N.J. 1984) (noting that "it is conceivable that an action by the IRS to recover any erroneous refund induced by a grossly negligent misrepresentation of a material fact will be barred if not brought within the five year limit of section 6532(b)"); Merlin v. Sanders, 144 F. Supp. 541, 543 (N.D. Ga. 1956) ("Willful misrepresentation is not required."), aff'd, 243 F.2d 821 (5th Cir. 1957). Contra United States v. Northern Trust Co., 93 F. Supp. 2d 903, 909-10 (N.D. Ill. 2000) (holding that misrepresentation must be intentional or knowing).[2]

Although "gross negligence" is a vague term, 57A Am. Jur. 2d Negligence § 243 (2002) (citing Thompson v. Bohlken, 312 N.W.2d 501, 504 (Iowa 1981)), for which there is no universally accepted definition, Fidelity Leasing Corp. v. Dun & Bradstreet, Inc., 494 F. Supp. 786, 790 (E.D. Pa. 1980), it is generally defined as a

[2] This citation is to an interlocutory order, and a final judgment has not been entered in the case. As such, the court's holding may be the subject of a future appeal.

failure to exercise even slight care, Prosser and Keeton on Torts § 34 (W. Page Keeton et al. eds., 5th ed. 1984). It is more than ordinary inattention or mistake, but less than "conscious indifference to the consequences." Prosser and Keeton on Torts, supra, § 34; see also Houston Exploration Co. v. Halliburton Energy Servs., 269 F.3d 528, 532 (5th Cir. 2001) ("Mere inadvertence or honest mistake does not amount to gross negligence."). In determining gross negligence, each case must be decided on its particular facts. Helms v. Leonard, 170 F. Supp. 143, 149 (W.D. Va. 1959), aff'd, 269 F.2d 48 (4th Cir. 1959).

On the particular facts of the example set forth above, we believe the employer's actions constituted gross negligence. The manner in which the employer made the payments gave every indication that the payments were made on behalf of the individuals' income tax liabilities and were not deposits satisfying the employer's withholding responsibilities. Additionally, the employer utterly failed to comply with the statutory and regulatory requirements for making deposits. The employer did not even provide its EIN with the payments or state the type of taxes being paid. The employer also failed to timely file a Form 945. Form 945 is required to be filed on January 31 of the year following the year for which the return is filed; for example, the filing date for the 1999 Form 945 was January 31, 2000. Individual income tax returns, Forms 1040, are, of course, not required to be filed until April 15 of the following year. Had the employer filed its Form 945 on time, the IRS might have been able to correct the misapplied payments before the individuals filed their returns and before the erroneous refunds based on those returns were made. The employer, however, did not file its return until after the refunds were made. Such negligence goes beyond ordinary or simple negligence. The employer did not exercise even slight care to ensure that the deposits would be correctly applied.

On these facts, the three elements of material misrepresentation under I.R.C. § 7405 are satisfied. First, there was a misrepresentation of fact. Through its negligence the employer misrepresented the nature of the payments as payments of the individuals' income tax liabilities rather than payments of the employer's employment tax liability. Second, the facts misrepresented, i.e., the type of tax being paid and the taxpayers to whom the payments related, were material. They were crucial to the erroneous refunds. Indeed, the refunds were erroneous because the payments were credited to the wrong taxpayers and as the wrong type of tax. Third, the employer's misrepresentation of material fact caused the erroneous refunds. Without the employer's misrepresentation, the refunds would not have been made.

We do not believe it matters that the employees or former employees who received the refunds and are the property parties to be sued did not commit the negligence amounting to misrepresentation of a material fact. The United States may pursue an erroneous refund action against whoever is in possession of the refunded monies. See Lindley v. United States, 59 F.2d 336 (9th Cir. 1932) (finding that although the United States was not entitled to maintain an erroneous refund action against executors who distributed the erroneous refund to decedent's legatees, the United States could maintain an action against the legatees); United States v. S.J.T., Inc., 72-2 U.S. Tax Cas. (CCH) ¶ 9722 (S.D. Tex. 1972) (granting judgment for the United States against two individual defendants in circumstances where a corporate taxpayer paid the erroneous refund over to the defendants' law partnership in payment of a preexisting debt for legal services). The United States could have sued the individuals to recover the refunds at any time within two years after the refunds were made, without having to prove fraud or misrepresentation, even though the individuals did not cause the refunds to be made. Now that the two years have elapsed, the United States should still have the right to recover the refunds from the individuals, if it can prove fraud or misrepresentation, regardless of who committed the fraud or misrepresentation.

Treatment of Payments and the Assessment of Unpaid Taxes

The employer's remittances to the IRS were not deposits of withheld taxes for purposes of the withholding and payment requirements of I.R.C. § 3405 because the employer did not comply with the deposit rules, and the remittances were properly treated as payments of the individuals' taxes. Because the employer did not make the deposits and has not otherwise paid the taxes, it is liable for, and the IRS may assess, the taxes.

The employer not only failed to comply with the deposit rules, but also gave no indication that the payments were deposits of withheld nonpayroll taxes. Moreover, the payments appeared to be payments by or on behalf of the individual employees or former employees, and the IRS was entitled to credit the payments to the individuals' tax accounts. The situation is analogous to that in Cindy's Inc. v. United States, 740 F.2d 851 (11th Cir. 1984), in which the appellant made a tax payment that appeared to be for another taxpayer, though intended as a payment of the appellant's liability, and the court held that the IRS properly treated the payment as a payment by the other taxpayer. In Cindy's the appellant made a deposit of withheld payroll taxes mistakenly using the preprinted coupon of another corporate taxpayer. 740 F.2d at 852. The IRS subsequently refunded the money to the other taxpayer. Id. The IRS then assessed the amount of the payment as a deficiency against the appellant, and the appellant paid the deficiency and filed a refund suit. Id. In upholding a judgment against the appellant, the court held that the appellant had not paid its taxes, finding that "applicable federal regulations prescribe that deposits of withholding tax must be accompanied by a correctly prepared [tax coupon] . . . ." Id. The court went on to note:

> Cindy's subjective intent is irrelevant. Cindy's manifested no intent to the federal depository except by the Form 501[, the payment coupon,] which indicated an intent to pay the taxes of [the other taxpayer] . . . . That the check was written by Cindy's is of no consequence. Federal

> depositories and the Internal Revenue Service are entitled to rely on the regulations detailing how withholding taxes shall be paid and the preprinted forms which are an integral part of the regulatory system. . . . There was no indication in this case . . . that Cindy's check was intended for any purpose other than to pay the taxes reflected on the Form 501.

Id. at 853 (citation omitted). As in Cindy's, the employer's payments manifested an intent to pay the employees' taxes, and there was no indication that the employer intended to pay its own taxes. And like the payment in Cindy's, the payments here were not, therefore, payments of the employer's taxes.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Any erroneous refund actions brought against employees or former employees involving the factual scenario detailed above would, to our knowledge, be novel litigation. As such, there are certain inherent hazards to this potential litigation, namely, that the court might find as a matter of law that the United States has no cause of action against the employees or that the facts, even if proven by a preponderance of the evidence, do not establish material misrepresentation, rendering the action barred by the statute of limitation. For the reasons set forth in this advice, however, we are of the opinion that the United States would have a viable case both legally and factually against any taxpayer who received an erroneous refund under the circumstances described.

Please call (202) 622-3630 if you have any further questions.