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

OFFICE OF
CHIEF COUNSEL

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SPR-111955-00

MEMORANDUM FOR RONALD S. RHODES
DEPUTY CHIEF, CUSTOMER SERVICE FIELD OPERATIONS - DALLAS

FROM: Heather Maloy
Associate Chief Counsel (Income Tax and Accounting)

SUBJECT: United States Department of Agriculture (USDA) Farmers' Settlement Claims

LEGEND:

Lawsuit:
Date 1:
Date 2:
Date 3:
Date 4:
Year 1:
Year 2:
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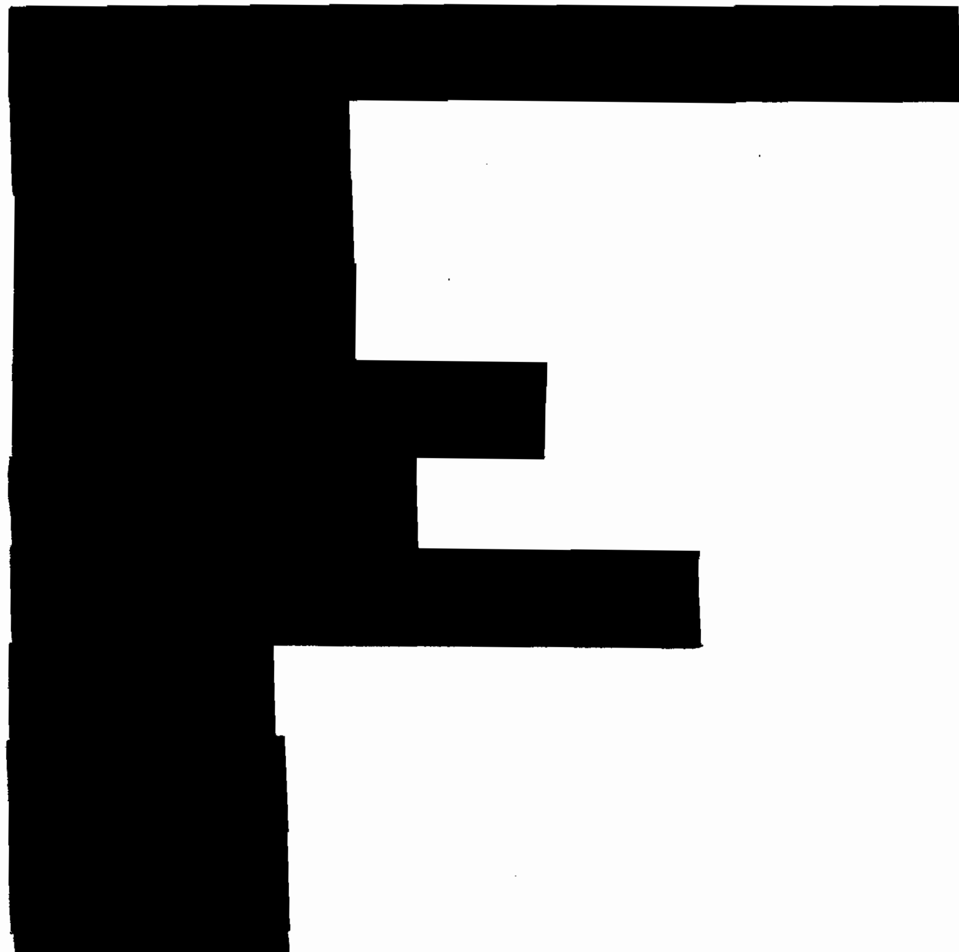

PMTA : 00410

This memorandum responds to your request for assistance dated July 5, 2000. In your request, you asked us to resolve certain legal questions regarding the settlement of the Lawsuit. We discussed these issues on July 21, 2000, in a meeting with you, other representatives of the Service, and representatives of the Office of Chief Counsel. In considering your questions, we became aware of some other issues that may be relevant to the administration of the settlement and have addressed those as well.

We have coordinated the responses in this memorandum with several other divisions in the Office of Chief Counsel. Thus, to facilitate the resolution of any additional questions you may have, we have provided the name and telephone number of the person who provided assistance on each response. Please contact any of us if we may be of further assistance.

Facts

On Date 1, g approved h settling the Lawsuit. In Year 1, approximately s class members settled their claims under a of the h. These claimants received a cash payment of \$t in Year 1 and, in some cases, a discharge of outstanding debt to b. The claimants received a Year 1 Form 1099-MISC for the amount of the cash award and a Year 1 Form 1099-C for the discharge of the debt.

On Date 2, in accordance with the h, c remitted tax payments to the Internal Revenue Service in the amount of u% of the cash payment (\$t) and also, if applicable, u% of the discharged debt. Funds for the tax payments were deposited under an EIN assigned to c specifically for judgment funds.

Each claimant was sent a letter dated Date 3, from the claims facilitator. This letter stated that (1) the Government made a tax payment of \$v, and if applicable, u% of the discharged debt, on their behalf; (2) the payment is considered taxable income in Year 2 and will have to be reported on their Year 2 tax return; and (3) they will receive a Form 1099 by January 31, Year 3, reflecting this payment.

Questions and Answers

1. **Is the "partial payment of tax" (so described in the h) a payment of tax or a deposit in the nature of a cash bond? If the remittance is a payment, on what date is the payment considered to be made, and is the remittance a payment of Year 1 tax or Year 2 tax?**

The "partial payment of tax" made on Date 2 is a payment of tax, not a deposit in the nature of a cash bond.[1] Under § 6513 of the Internal Revenue Code this payment is considered made on April 15, Year 2 (last day prescribed for payment of Year 1 tax).[2] The claimant thereby receives credit for a payment of Year 1 tax. Claimants cannot elect to treat any portion of this tax payment as a tax payment for Year 2 and the Service has no discretion in this regard. On the other hand, the claimant may elect under § 6402(b) to treat the overpayment shown on the Year 1 return (not the tax payment itself) as an estimated tax payment for Year 2.

We understand that for processing purposes the Service would prefer to "code" the partial payment of tax as an estimated tax payment instead of an advance payment of tax. Both types of payments are described in § 6513. We have no objection to coding the payment in this manner because such a coding should not have adverse tax consequences to the claimant. Under § 6513, the payment would still be credited against the tax liability effective April 15, Year 2, and under § 6654(b), the payment would be applied to any underpayment of estimated tax as of the date it was paid to the Service.

Contact Person: Michael Gompertz, CC:APJP:2, 622-8162

Can the "partial payment of tax" for Year 1 be offset against other tax liabilities or nontax debt and the balance refunded to the claimant?

The partial payment of tax cannot itself be offset against other tax or nontax debt. However, the partial payment of tax may cause a claimant to have an overpayment for Year 1 (an overpayment equals the total amount of tax paid in excess of the tax liability). Under § 6402, such an overpayment may be offset against tax liability for other years and will be offset against nontax debt (e.g., student loan obligations). Any amount remaining after the offsets will be refunded to the claimant.

Contact Person: Michael Gompertz, CC:APJP:2, 622-8162

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[1] The issue of payment vs. deposit is resolved on the basis of "intent, which may be determined from the circumstances such as when the tax liability was created, the taxpayer's purpose in remitting the money, and how the IRS treated the payment." Blatt v. United States, 34 F.3d 252, 255 (4th Cir. 1994).

[2] April 15, Year 2, was d, but this does not mean that the date prescribed by law for filing the tax return or paying the tax is changed to e Date 4. A payment made on Date 2 is considered made on April 15, and a payment made on Date 4 is timely even though it is not considered as made on April 15. Rev. Rul. 81-269, 1981-2 C.B. 243.

What is the last date for claiming a refund of the partial payment of tax?

The partial payment of tax is not itself refundable as stated above. However, the partial payment of tax may result in an overpayment. If there is an overpayment for Year 1, the claimant may obtain a refund of that amount by filing an original return claiming a refund on or before April 15, Year 4.[3] See §§ 6511(a) and (b)(2)(A) and Rev. Rul. 76-511, 1976-2 C.B. 428.

If the claimant does not file a tax return, the claimant's refund claim for Year 1 (including an informal claim) must be filed within 2 years from the time the tax was paid (April 15, Year 2). Sections 301.6511(a)-1(a)(2) and 301.6511(b)-1(b)(1)(iii).

In order to issue a refund, the Service must first determine that a claimant has made payments in excess of the claimant's tax liability. Normally, the Service would need the claimant to file a return or claim for refund in order to make such a determination. However, the Service may issue a refund if such a determination can be made without the filing of a return or claim. See § 6020(b), which permits the Service to prepare a return on a taxpayer's behalf and § 6511(b)(2)(C), which provides a limit on the amount that can be refunded if no claim for refund is filed. If the claimant does not file a return or a refund claim, any amount refunded or credited by the Service must be "allowed" no later than 2 years from the time the tax was paid (April 15, Year 2). Section 6511(b)(2)(C) and § 301.6511(b)-1(b)(iv). The date the refund is "allowed" is the date Form 2188, Voucher and Schedule of Overpayments and Overassessments, is signed. General Instrument Corp. v. United States, 33 Fed. Cl. 4 (1995).

Contact Person: Michael Gompertz, CC:APJP:2, 622-8162

If the "partial payment of tax" is taxable income, does the claimant recognize the income in Year 1 or Year 2?

First, we note that the partial payment of tax is gross income under § 61, which provides that gross income means all income from whatever source derived. See also § 1.61-4 of the Income Tax Regulations. Section 1.61-14 specifically provides that another person's payment of a taxpayer's income taxes constitutes gross income to the taxpayer unless excluded by law.

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[3] Such a delinquent return must be received by the Service on or before April 15, Year 4. Neither § 7502 (timely mailing treated as timely filing) nor § 7503 (Saturday, Sunday, or holiday rule) would apply to such a delinquent original return.

The determination of when the claimant should recognize the partial payment of tax in income depends first on whether the claimant uses an accrual method of accounting or the cash receipts and disbursements method (cash method). A small number of claimants may use an accrual method of accounting. Under an accrual method, income is includible in gross income when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. Section 1.451-1(a).

Section w of the h provides that in any case in which the i decides that the claimant has demonstrated by substantial evidence that he was the victim of discrimination, a payment equal to u% of the sum of $t plus the principal amount of any debt forgiven shall be made by electronic means directly from the judgment fund to the Service as partial payment of the taxes owed by the claimant on the amounts paid or forgiven pursuant to the h. The decision of the i is final, except in a case in which the j determines that a clear and manifest error has occurred and that a miscarriage of justice has resulted or is likely to result. Thus, we think that a claimant using an accrual method has a fixed right to receive the tax payment at the time the i makes his decision (1999). Further, at that time the claimant is able to determine the amount of the tax payment with reasonable accuracy, based on the formula provided in the h. Although the h provides for the possibility that the j could direct the i to reexamine a claim in certain limited circumstances, we think this would be unlikely in the case of a claim that had been approved, and in any case would be a condition subsequent to the all-events test being met.

For claimants using the cash method of accounting, income is includible in gross income for the taxable year in which it is actually or constructively received by the claimant. The claimants did not have actual receipt of the tax payment in Year 1. Thus, the issue is whether the claimants had constructive receipt of the income in Year 1, or whether the claimants must recognize the income in Year 1 under either of two doctrines created by the courts, the cash equivalency doctrine or the economic benefit doctrine.

Section 1.451-2 provides that income is constructively received by a taxpayer in the taxable year in which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. Section 1.451-2. In this case, it is clear from the h that the tax payment was being made directly to the Service, and that the claimant did not have the option of receiving cash in lieu of the tax payment to the Service. Neither is there any indication that a claimant had any control over the date on which the tax payment would be transmitted to the

Service. Thus, the tax payment was not available to the claimant in Year 1 and therefore was not constructively received in Year 1.

The courts have also created two doctrines that require taxpayers to recognize income upon the receipt of certain promises to pay in the future. Under the first of these doctrines, the cash equivalency doctrine, a taxpayer is treated as having income when he receives a promise to pay that is the "equivalent of cash." In Cowden v. Commissioner, 289 F.2d 20 (5th Cir. 1961), the court described the doctrine as follows:

> If a promise to pay of a solvent obligor is unconditional and assignable, not subject to set-offs, and is of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money, such promise is the equivalent of cash and taxable in like manner as cash would have been taxable had it been received by the taxpayer rather than the obligation.

In this case, although b is a solvent obligor and b's promise to make the tax payments is unconditional, the h indicates that the tax payments were to be paid by c directly to the Service. Thus, b's promise to make the tax payments on behalf of the claimants could not be assigned by the claimants. Further, b's promise to pay is not of a kind that is frequently transferred to lenders or investors. Thus, the cash equivalency doctrine does not require the tax payments to be included in the claimants' gross income in Year 1.

The other court-created doctrine that requires taxpayers to recognize income upon the receipt of a certain type of promise to pay in the future is the economic benefit doctrine. Economic benefit applies when assets are unconditionally and irrevocably paid into a fund or trust to be used for a taxpayer's sole benefit. Sproull v. Commissioner, 16 T.C. 244 (1951), aff'd per curiam, 195 F.2d 541 (6th Cir. 1952); Rev. Rul. 60-31, 1960-1 C.B. 174 (Situation 4). In Sproull, the court established the current elements of the economic benefit doctrine. At issue in Sproull was the taxability of amounts paid by the taxpayer's employer to an interest bearing trust as compensation for taxpayer's past services. In finding that the taxpayer obtained an economic benefit in the year the trust was established, the court noted that the funds were placed in trust irrevocably for the taxpayer's sole benefit and that the taxpayer had to do nothing further to establish his right to the funds.

In the instant case, the claimants in Year 1 had an irrevocable right under the h for the tax payments to be made on their behalf. The claimants had to do nothing further to establish their right to those payments. However, the tax payments in this

case were not paid into any kind of trust or fund for the taxpayer's sole benefit. Instead, after the i decided that claimants qualified to receive payments, f computed the amount of tax that would be paid on behalf of each claimant (u% of the sum of $t plus any discharge of indebtedness) and forwarded that amount on a spreadsheet to c. On Date 2, c paid the tax amounts by electronic transfer directly to the Service from the "judgment fund."

The h does not define "judgment fund" but states that it is described in 31 U.S.C. § 1304. That statute is part of Title 31, Money and Finance, Subtitle II, The Budget Process, Chapter 13, Appropriations, Subchapter I, General. Section 1304 provides that necessary amounts are appropriated to pay final judgments, awards, compromise settlements, and interest and costs specified in the judgments or otherwise authorized by law under certain circumstances. The judgment fund legislation, as it is called, authorizes no claims for relief, but is auxiliary legislation whose sole purpose is to furnish a mechanism for facilitating payment of judgments rendered on claims authorized by another statute. Trout v. Garrett, 891 F.2d 332 (1989). The primary purpose in establishing this permanent appropriation was to provide for prompt payment of judgments and thereby to eliminate or reduce costs of interest. United States v. Varner, 400 F.2d 369 (5th Cir. 1968). Thus, the judgment fund is not a trust or escrow account that was set up for the sole benefit of the claimants. Further, the tax payments were not "paid into" the judgment fund; instead, the judgment fund is merely a standing appropriation by Congress that was established to pay judgments in a timely manner.

Further, while the economic benefit doctrine requires taxpayers to include in gross income the receipt of a funded and irrevocable promise to pay, it is clear that the receipt of a mere promise to pay, not represented by notes or secured in any way, is not required to be reported in income. Rev. Rul. 60-31 (citations omitted). In the instant case, even after a decision by the i that a claimant qualified for the settlement, the h provided no more than a mere promise that b would make tax payments to the Service on behalf of the claimant.

Contact Person: Kim Koch, CC:IT&A:5, 622-4950

2. May claimants be required to file an amended return for Year 1?

No statutory provision requires the filing of an amended return, which has been described as "a creature of administrative origin and grace." See Badaracco v. United States, 464 U.S. 386, 393, 397 (1984).

Contact Person: Michael Gompertz, CC:APJP:2, 622-8162

Does the IRS have the administrative discretion to provide a blanket waiver of any penalties that would be due? If penalties and/or interest is due because the "partial payment of tax" was not credited to the claimants' accounts, can the penalties and interest be abated?

The partial payment of tax should be credited to the claimants' accounts as of April 15, Year 2. This will reduce the balance due amount and in some cases may result in an overpayment for Year 1. As a result, the applicable penalties (e.g, failure-to-file and failure-to-pay penalties under § 6651) will generally be reduced or eliminated. Similarly, there should be a reduction or elimination of interest liability. The abatement statute (§ 6404) will not generally apply except in the most obvious sense, i.e., certain amounts may have been "erroneously assessed" under § 6404(a)(3) because no credit was given for the tax payment. Once the tax payments are properly credited as described above, a blanket penalty waiver or abatement is not necessary.

Also, it is our understanding that the Service may have computed the tax liability for Year 1 based on a determination that the debt discharge amount is fully taxable. To the extent that this amount is nontaxable or partially taxable, the tax liability will have been overstated, which would cause a corresponding overstatement of the failure-to-pay and failure-to-file penalties and interest. The assessment of these penalties and interest should be abated to the extent of any overstatement of penalties or interest caused by full inclusion of the debt discharge amount in gross income.

Contact Person: Michael Gompertz, CC:APJP:2, 622-8162

3. **Is the cash payment, discharge of indebtedness, and/or the "partial payment of tax" deemed earned income for the earned income tax credit (EIC)?**

The analysis of this question is the same for all components of the settlement payments (the $t, the $v, and any loan forgiveness). Three questions arise:

1. Are the payments disqualified income?

Disqualified income under § 32(i)(2) includes taxable interest and dividends, tax-exempt interest, and certain other types of investment income. The settlement payments fit into none of these categories.

2. Are the payments earned income?

but was nonetheless deemed the partners' income tax return preparer). Thus, tax professional X constitutes an income tax return preparer within the meaning of section 7701(a)(36).

Scenario 4: Same result as in Scenario 3.

Scenario 5: "A person who prepares a return for compensation may be an income tax return preparer even though that person does not actually place the figures on the lines of the taxpayer's final tax return." H.R. Rep. No. 658, 94th Cong., 1st Sess., at 275 (1975); S. Rep. No. 938, 94th Cong., 2d Sess., at 351 (1975). Thus, in this scenario, even though tax professional X does not place the figures on the taxpayer's return, tax professional X could constitute an income tax return preparer with respect to that return. To the extent a substantial portion of the taxpayer's income tax return consists of entries for which the taxpayer sought advice from tax professional X, tax professional X is an income tax return preparer within the purview of section 7701(a)(36). However, if the taxpayer requests advice that is not directly relevant to the existence, characterization or amounts of entries that consisted of a substantial portion of the taxpayer's income tax return (e.g., the due date for filing the return, or whether the taxpayer can use Form 1040EZ), tax professional X is not an income tax return preparer. Moreover, if tax professional X provides advice that causes the taxpayer to change his address on the return, this advice is a mere ministerial act and does not constitute the preparation of a substantial portion of a return. United States v. Deaton, 754 F.Supp. 102 (W.D. Ky. 1990).

Given the Service's reasoning in Rev. Rul. 85-188 and Rev. Rul. 86-55, the compensation element in Scenario 5 should be satisfied. In both of those rulings, the Service concluded that by offering "package deals" that included tax assistance, the existence of a separate fee for the tax assistance was not required. Similarly, in the present situation, the fact that there is no separate charge for the tax advice is irrelevant; although the tax advice may constitute a relatively small portion of the total software product purchased, it is clear that the amount of the compensation in a "package deal" has no bearing on whether someone is an income tax return preparer. Tax professional X is treated as receiving compensation for his services even though the taxpayer did not actually pay tax professional X, as tax professional X's compensation is included in the price of the software. Thus, so long as the "substantial portion" element of the definition is satisfied, tax professional X is an income tax return preparer.

Scenario 6: As discussed above, Rev. Rul. 85-188 and Rev. Rul. 86-55 make clear that whether the compensation element is satisfied in a "package deal" is not governed by the amount of compensation attributable to the return preparation; as long as compensation exists, whether nominal or substantial, the compensation element of the definition will be met.

In Rev. Rul. 84-3, the Service has indicated that when a taxpayer submits a draft of an income tax return to a consultant for review in its entirety for both substantive correctness and mechanical accuracy and the consultant recommends substantial changes which the taxpayer makes, the consultant is properly classified as an income tax return preparer. Similarly, the tax consultant was classified as an income tax return preparer when he reviewed a return prepared by a taxpayer for accuracy and substantive correctness and neither recommended nor made any changes to the return. In Rev. Rul. 86-55, a review of a return by a person who was not in the business of tax preparation that was prepared by a taxpayer for both substantive correctness and mechanical accuracy constitutes preparation of a return for purposes of section 7701(a)(36). Thus, by reviewing taxpayer's return in exchange for compensation in this "package deal," tax professional X in this scenario is an income tax return preparer within the meaning of section 7701(a)(36).

With respect to whether an individual must sign the return as a preparer, section 6695(b) requires that an income tax return preparer with respect to a return of tax or claim for refund must sign the return or claim for refund in the appropriate space provided on the return or claim for refund. Failure to sign as the preparer results in a penalty of $50 per return. As discussed above, each of the five elements of the definition of income tax return preparer must be satisfied for a person to constitute a preparer. Although the definition of an income tax return preparer is the same for sections 7701(a)(36) and 6695(b), absent evidence to the contrary, a signature on a return in the space reserved for paid preparers is sufficient proof that a person is an income tax return preparer. United States v. Bohonnon, 628 F.Supp. 1026 (D. Conn. 1985), aff'd without opinion, 795 F.2d 79 (2d Cir. 1985). Moreover, compensation for preparing a return coupled with a signature on the line on the income tax return designating the signature of a paid preparer results in the conclusion that a person is an income tax return preparer within the meaning of section 7701(a)(36). United States v. Venie, 691 F.Supp. 834 (D. Penn. 1988).

As discussed above, tax professional X in Scenario 2 is an income tax return preparer when he reviews Form 1040 in exchange for compensation. Thus, section 6695(b) mandates that tax professional X sign the return as the income tax return preparer. However, let's assume that tax professional X in Scenario 2 does not review the return at all, but wishes to sign the return as the preparer. In theory, tax professional X should not be subject to the penalty under section 6695(b), as the five elements of the definition of an income tax return preparer are not present. However, nothing in the statutes or regulations prohibits tax professional X from signing the return as the preparer. As a result, tax professional X may sign the return, but should be wary that in doing so, such signature may be sufficient to subject tax professional X to the requirements and penalties imposed for income tax return preparers.

By: [signature]
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