Office of Chief Counsel
Internal Revenue Service
Memorandum

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subject: Request for reconsideration of advice on I.R.C. § 6702 and its application to returns claiming a foreign earned income exclusion

This Chief Counsel Advice responds to your request that we reconsider our June 3, 2004 advice concerning the review of your draft opinion relating to returns in which the taxpayer inappropriately claimed a foreign earned income exclusion.

This advice may not be used or cited as precedent.

ISSUES

1. Whether the IRS can use deficiency procedures to recover an erroneous refund made as a result of an inappropriately claimed foreign earned income exclusion.

2. Whether the unlimited statute of limitations under section 6501(c)(1) applies per se to these returns.

CONCLUSIONS

1. The IRS can use deficiency procedures to recover an erroneous refund made as a result of an inappropriately claimed foreign earned income exclusion.

2. The unlimited statute of limitations under section 6501(c)(1) does not apply per se to these returns.

FACTS

Your draft opinion involves certain taxpayers who have inappropriately claimed a refund by using Form 2555 (Foreign Earned Income) or Form 2555-EZ (Foreign Earned Income Exclusion) to claim a foreign earned income exclusion under section 911. This exclusion allows U.S. taxpayers to exclude income from taxation in the United States if the taxpayer earned that income for services performed in a foreign country. The taxpayers list domestic addresses instead of foreign addresses on the form as their "foreign address" and their "Employer's foreign address." These taxpayers then claim a refund of withheld taxes, based on the foreign earned income exclusion.

Specifically, you asked that we reconsider the following conclusions:

1. The IRS cannot use deficiency procedures to recover an erroneous refund made as a result of the inappropriately claimed foreign income exclusion.

2. The unlimited statute of limitations under section 6501(c)(1) does not apply per se to these returns.

LAW AND ANALYSIS

Issue 1: Whether the Service can use deficiency procedures

In the draft opinion, you recommended that a notice of deficiency be issued following the issuance of an erroneous refund based on an inappropriately claimed foreign earned income exclusion. In our June 3, 2004 advice (response memorandum), we arrived at the opposite conclusion because the tax shown on the returns would be zero; the refund, therefore, would not be a rebate erroneous refund and deficiency procedures could not be used. Your request for reconsideration expressed concern that, by following our logic, the Service could never determine a deficiency when a taxpayer claimed deductions and credits to reduce the tax to zero. This would occur even when the taxpayer could not substantiate the deductions or credits and even when such deductions and credits relied on totally false and frivolous claims. Based on the analysis below, we agree that the Service can use deficiency procedures in the subject cases.

Section 6212(a) provides that if the Secretary determines there is a deficiency with respect to various types of tax, including income tax imposed by subtitle A, the Secretary is authorized to send a notice of such deficiency to the taxpayer. Section 6211(a) sets out the definition of deficiency by using the following formula: a deficiency equals the correct tax imposed minus the total of the tax on the taxpayer's return minus prior assessments plus rebates. Section 6211(b)(1) provides that the tax imposed by subtitle A shall be determined for the purposes of section 6211(a) without regard to the credit under section 31 (tax withheld on wages). By reference to the first part of the definition of the deficiency formula (correct tax minus the tax shown on the return), disallowance of the foreign earned income exclusion will result in actual taxable income and a correct tax amount exceeding the $0 amount shown on the return (assuming that items such as the standard deduction or exemptions do not reduce the correct tax to $0). Thus, there will be a deficiency which is determined by reference to the first part of the formula. Deficiency procedures can and should be used in this situation.

Issue 2: Application of the unlimited statute of limitations under section 6501(c)(1)

In the draft opinion, you concluded that the Service could rely on the unlimited statute of limitations in section 6501(c)(1) to assess a deficiency in cases where the inaccuracy of the return is discovered after a refund has been issued and the general three-year statute of limitations has passed. Section 6501(c)(1) allows the Service to assess a deficiency at any time in the case of a "false or fraudulent return with the intent to evade tax."

In our response memorandum, we stated that section 6501(c)(1) may apply to some of these returns, but we recommended that other options be explored before the Service relied on the unlimited statute of limitations because we were unwilling to find that all of the returns of this nature automatically satisfy the requirements of the statute. Your concern is that our analysis focused on the fraudulent requirement in section 6501(c)(1), and disregarded the word "false" in the statute, thereby imposing a higher burden of proof on the Service. Based on the discussion below, we affirm our analysis and conclusion.

Your request for reconsideration correctly points out that the unambiguous wording of the statute includes "false" as well as "fraudulent" returns. The statute, however, also clearly provides that both types of returns have to have been made with the intent to evade tax in order for the exception to the general three year statute of limitations to apply. Because intent is subjective and a question of fact -- a facts and circumstances situation --, the Service needs to examine the specifics of each taxpayer's case to determine if the taxpayer had the intent to evade tax. While such intent cannot be imputed or presumed, it may be proved by circumstantial evidence and reasonable inferences drawn from the facts and the taxpayer's pattern of conduct because direct proof of intent is rarely available. Spies v. United States, 317 U.S. 492 (1943); Miller v. Commissioner, 94 T.C. 316, 333 (1990). Courts have supported relying on certain "badges" or indicia of fraud, such as (1) understatement of income; (2)

inadequate records; (3) failure to file tax returns; (4) implausible or inconsistent explanations of behavior; (5) concealment of assets; and (6) failure to cooperate with tax authorities. Miller, 94 T.C. at 334.

The response memorandum's analysis focused on the definition of fraud and cases involving "fraudulent returns" for several reasons. First, there are few, if any, cases that specifically only deal with a "false return with the intent to evade tax." See generally Brister v. United States, 35 Fed. Cl. 214, 219 (1996) (stating that the Court was unable to find any cases that construed the term false under section 6501(c)(1)). Second, there are few if any cases that directly discuss any distinction between a "false return with the intent to evade tax" and a "fraudulent return with the intent to evade tax." See generally Id. at 220 (stating that the Court was unable to find any cases discussing whether the terms false and fraudulent in this section are meaningfully distinct). Third, regardless of whether the return is considered "false" or "fraudulent," the Service must prove that the returns were made with the "intent to evade tax."

Fraud is commonly defined as the intent to evade tax that the taxpayer knows is owing. See, e.g. Miller, 94 T.C. at 332. Consequently, the cases and analysis in our response memorandum dealing with the definition of fraud and the requirements of proving fraud are instructive to show the requirements of "intent to evade tax." Thus, the response memorandum focused on fraud and our unwillingness to find that these returns were "per se fraudulent" in order to show why section 6501(c)(1) does not apply to all of the returns, but instead will apply only if the facts of a particular case so warrant.

It is our understanding that the nature of the frivolous return program does not lend itself to routinely developing the facts and circumstances necessary to support a fraud determination. Thus, we cannot recommend that a notice of deficiency be issued if the general three year statute of limitations has passed and the issuance is based on section 6501(c)(1). It seems unlikely that the service center examiner could have ascertained sufficient information about the intent of the taxpayer(s) to support the issuance of a notice of deficiency based on the taxpayer(s) having made the return with the intent to evade tax.

Furthermore, we cannot recommend issuing a notice of deficiency at the completion of the frivolous return program review because of the litigation hazards inherent in the dearth of factual inquiry. First, the Service bears the burden of proof and, thus, must prove that the taxpayer intended to evade tax known to be owing by clear and convincing evidence. See, e.g., Midler Cotler Trust v. United States, 184 F.3d 168, 173 (2d Cir. 1999). If the Service were to issue a notice of deficiency only after further factual development, it would be in a better position to meet its burden. Alternatively, the Service may discern upon further factual development that the facts do not support its burden, obviating any need to issue a notice of deficiency.

In addition, if a taxpayer petitions the Tax Court after receiving the notice of deficiency, and the Service files a pleading based solely on the frivolous return program

examination, the Service may violate a Tax Court rule. For example, the Tax Court requires that the signer of a pleading certify that (1) the signer has conducted a reasonable inquiry and (2) the pleading is well grounded in fact. Tax Ct. R 33(b). T.C. Rule 33(b). It seems unlikely that the Service could make such certifications based on the frivolous return program examination. The Service would be in a similar situation if litigation arose in another court, as the Court of Federal Claims and the district courts have similar rules. See, e.g., Fed. R. Civ. P. 11.

Therefore, if the Service discovers that an erroneous refund has been issued after the general three year statute of limitations has passed, the Service should conduct an examination to determine whether the indicia of fraud are present. In many, if not most, instances the Service may not need to conduct an extensive examination before determining whether the taxpayer had the intent to evade tax.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

There are no hazards or other considerations.

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If you have any further questions, please call (202) 622-4940.