Office of Chief Counsel
Internal Revenue Service
Memorandum

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subject:

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

LEGEND

Employee =

Estate =

Employer =

Position =

Years =

$A =

$B =

$C =

$D =

$E =

$F =

$G =

$H =

$I =

$J =

Date 1 =

Date 2 =

ISSUES

1. May the Service refund or return funds to the victim of an embezzler when the embezzler used the funds to make estimated tax payments on the embezzler's 2001 income tax account?

2. If the funds may be returned, procedurally how should it be accomplished?

CONCLUSIONS

1. The Service may not return estimated tax payments made by an embezzler for his individual income tax liability to the embezzler's victim.

2. While this question is moot, the Service may wish to consider starting a non-filer investigation if the embezzler's estate will not provide information allowing the Service to determine the embezzler's income tax liability. Once the liability is determined, the estate could transfer any refund for overpayment of the income tax liability to the victim.

FACTS

Employee was the Position for Employer. During an audit of its finances in Date 1, Employer discovered that Employee had been embezzling for approximately Years. Employee used some of the embezzled funds to make estimated tax payments on his individual income tax account for . Employer is seeking to recover from the Service $A in estimated tax payments that are posted to Employee's account.

(No return has been filed for and the estimated tax payments have not yet been applied to a tax assessment.)

Employee’s embezzlement scheme worked as follows: Employer had two accounts titled “General Fund” and “Capital Improvement.” As Employer’s Position, Employee received checks from various sources payable to Employer. He would deposit these checks into Employer’s Capital Improvement account. He would then draft a check from Employer’s General Fund account payable to “Capital Improvements Fund” in the same amount as the deposit, making it appear that Employer was transferring funds from one of its accounts to the other. Employee, however, deposited the checks payable to “Capital Improvements Fund” into a personal account he established entitled “Capital Improvements.” Employee then used his “Capital Improvements” account to purchase cashier’s checks which he used to make his estimated tax payments (one $D payment was made by a check written on Employee’s “Capital Improvements” account).

The following estimated tax payments were posted to Employee’s income tax account:

Date	Amount
07/30/01	$B
01/15/02	$C
04/15/02	$D
	$A

No income tax return has been filed by Employee for the year , and the amount of his estimated tax liability is unknown. Third party information returns show income totaling $E as follows: $F, $G, $H, and $I. His income tax liability, as reported on his return, for the year 2000 was $J.

Employee was prosecuted for the embezzlement and was sentenced to state prison, where he died in Date 2. The Estate has released any interest it has in the $A on deposit with the Service to Employer and has agreed to cooperate with Employer to effectuate a return of the $A to Employer. Employer has stated that it is entitled to the funds under a constructive trust theory.

LAW AND ANALYSIS

Refund of overpayment

Section 6402(a) of the Internal Revenue Code provides, in part, that in the case of any overpayment, the Secretary may credit the amount of such overpayment against any tax liability of the person who made the overpayment and shall refund the balance to such person. This section authorizes the Service to credit or refund any overpayment of tax only to the “person who made the overpayment.” An “overpayment” is the amount by which payments made by the taxpayer exceed the correct tax liability. Jones v.

Liberty Glass Co., 332 U.S. 524 (1947). The Service is authorized to make a refund only if an overpayment exists. Lewis v. Reynolds, 284 U.S. 281 (1932).

A person who voluntarily pays the tax of another does not have standing to sue for a refund in the district courts or the Court of Federal Claims under the jurisdiction granted those courts under 28 USC § 1346(a)(1). The Service, and several circuit courts, have taken the position that only the taxpayer against whom the tax was assessed may bring a tax refund suit under that provision. See Pershing Div. of Donaldson, Lufkin & Jenrette v. United States, 22 F.3d 741 (7th Cir. 1994). Other circuits, however, have disagreed. See Martin v. United States, 895 F.2d 992 (4th Cir.1990).

In Pershing an embezzler made estimated tax payments on behalf of a sham corporation created only for the purpose of laundering embezzled funds. Pershing argued as follows to establish standing to bring a tax refund action for the funds:

> (1) 28 USC § 1346(a)(1) does not explicitly limit refund actions to the taxpayer, citing Martin; and, alternatively,
>
> (2) if the court were to impose such a requirement, Pershing should be recognized as the taxpayer under a theory of constructive or involuntary payment.

22 F.3d at 742.

The Seventh Circuit rejected these arguments, following the rule that only persons legally liable for paying federal tax may bring a refund suit. The Seventh Circuit's citations included its own precedent in Busse v. United States, 542 F.2d 421, 425 (7th Cir. 1976) and the Fifth Circuit's in Snodgrass v. United States, 834 F.2d 537, 540 (5th Cir. 1987).

Subsequent to Pershing, the Supreme Court recognized an exception to the general rule for a claimant who paid tax assessed against her spouse to remove a federal tax lien from property he had transferred to her. See United States v. Williams, 514 U.S. 527 (1995). Williams allowed a refund suit by a plaintiff who paid tax assessed against her spouse, to remove a federal tax lien from property he had transferred to her. The plaintiff needed to remove the lien to sell the property, and, therefore, paid the tax under protest with the proceeds of the sale. The Supreme Court's decision was influenced by the belief that absent paying the tax, the plaintiff had no other meaningful remedy for removing the lien and, thus, was subject to tax for purposes of 28 U.S.C. § 1346(a)(1). In additional, the Supreme Court suggested that the plaintiff could be considered to meet the definition of a taxpayer for purposes of the Internal Revenue Code.

In Williams, the Supreme Court noted that the District Court accepted the argument that 28 USC § 1346(a)(1) authorizes actions only by the assessed party, relying on precedent set in the Fifth (Snodgrass) and Seventh (Busse) Circuits. See 514 U.S. at 531 at note 3. The Ninth Circuit reversed the District Court in Williams v. United

States, 24 F.3d 1143 (9th Cir. 1994), aff'd 514 U.S. 527 (1995) and the Supreme Court affirmed the Circuit Court.

In our view, Williams should be read narrowly, limited to the facts presented in that case. The present case does not involve a payment made under protest to remove a federal tax lien and, therefore, Williams is distinguishable. Additionally, the employer did not make a payment to the Service in this case, and so would not qualify as a taxpayer even under a broad reading of Williams. Moreover, even if a court were to disagree with our reading of Williams and decide that Pershing has no life after Williams, such a decision would not give the victim in the subject case standing to obtain a refund. Unlike Pershing, where the sham entity that pays the tax has no tax liability to be assessed and the victim can be deemed to be the person who paid the tax, in the subject case where the embezzler directs the funds into his own tax account, the money at issue was actually paid by the person with a tax liability to be assessed and that person has the standing to obtain a refund of any money overpaid.

We recognize that these are sympathetic facts because the embezzled funds can be traced to the wrongdoer's tax account; however, the Service has no authority to put the government in a worse position than other creditors of the wrongdoer who have no knowledge or notice of an embezzlement. That is, if the wrongdoer paid a third party for services or goods with embezzled funds, the victim could not obtain the funds from the third party; instead, the victim's cause of action is against the wrongdoer. Accordingly, to the extent that Employee would have been entitled to a refund, Employer may be entitled to obtain that amount from Estate. We do not recommend paying any such refund to Employer as state law controls the disbursement of Estate's assets to Employee's creditors.

Constructive trust

A constructive trust is an equitable remedy applied by many jurisdictions, including Kentucky, to provide relief to the injured party for property acquired by another by means of fraud.

> The essence of the doctrine of constructive trusts is equitable in nature and devised by courts to prevent a party from benefiting to the detriment of another by wrongful conduct. A constructive trust may be imposed to restore beneficial ownership when legal title has been lost due to illegal, deceptive or unconscionable behavior by the titleholder.

Bjorkman v. Protestant Episcopal Church in United States of America of Diocese, 759 S.W.2d 583, 587 (Ky. 1988); see also Kaplon v. Chase, 690 S.W.2d 761, 763 (Ky. Ct. App. 1985) ("a constructive trust is an equitable remedy which provides relief from a fraud or breach of confidence"); Lowe v. Lowe, 229 S.W.2d 442, 443 (Ky. 1950) ("constructive trusts never arise except where the holder of the legal title obtained it through fraud, misrepresentation, concealments, undue influence, duress, or some other wrongful act whereby another is deprived of the title to his property").

Even if a constructive trust would be an appropriate remedy for Employer, such a trust does not exist until created by a court. "A constructive trust is a legal fiction, a common-law remedy in equity that may only exist by the grace of judicial action." In re Omegas Group, Inc., 16 F.3d 1443, 1449 (6th Cir. 1994) (holding that a creditor's mere claim of entitlement to constructive trust based on the debtor's alleged fraudulent prepetition acts was not an "equitable interest" in debtor's property such as would exclude it from property of the bankruptcy estate).

Furthermore, even if a constructive trust is properly imposed, one must still look to federal tax law to determine the effect of the constructive trust on the funds sought. See Blachy v. Butcher, 221 F.3d 896 (6th Cir. 2000) (holding that a constructive trust that is judicially imposed after the filing of a federal tax lien cannot retroactively meet the federal standard of "choateness" because federal law makes no provision for the subordination of a tax lien through the use of the "relation back" doctrine). Accordingly, because no court had created a constructive trust at the time Service received the estimated tax payments, the Service cannot be divested of the funds under the constructive trust remedy.

Return of deposit in the nature of a cash bond

Every remittance to the Service is not a payment of a tax liability; a taxpayer may designate certain payments as deposits and the taxpayer can simply request a return of a deposit. To determine whether a remittance is a payment or a deposit, generally courts determine whether, based on all of the facts and circumstances associated with the remittance, the remitter intended to satisfy what he or she regarded as an existing tax liability. Ameel v. United States, 426 F.2d 1270, 1273 (6th Cir. 1970). With regard to remittances of installments of estimated income tax, however, no determination of the remitter's intent is necessary because such remittances are deemed paid on the deadline (determined without regard to extensions) for filing that year's return and are tax payments as a matter of law. See Baral v. United States, 528 U.S. 431, 437 (2000) at footnote 2; compare Risman v. Commissioner, 100 T.C. 191, 202 (1993), nonacq., 1998-1 C.B. 5[1] and Gabelman v. Commissioner, 86 F.3d 609 (6th Cir. 1996), which concern remittances submitted with a request for an automatic extension of time to file (the Tax Court held that that the remittance was not a payment if the taxpayer did not make a good faith effort to estimate his liability whereas the Sixth Circuit held the remittance was a tax payment; both, however, agreed that installment payments of estimated tax would be tax payments). Accordingly, in the subject case, Employee

[1] See Revised Action on Decision CC-1997-006 (May 5, 1997) stating the Service agrees with Gabelman that remittances sent with a Form 4868 should not be treated differently than remittances of estimated tax payments and, therefore, a remittance sent with a Form 4868 is a payment of tax as a matter of law.

made payments of tax and not deposits. We note that the fact that the Service has not yet assessed any tax for Employee’s 2001 tax year has no bearing on the treatment of a remittance for estimated tax. 528 U.S. at 437-8.

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