ACKNOWLEDGED SIGNIFICANT ADVICE, MAY BE DISSEMINATED

ACKNOWLEDGED 9-10-97
SCA 1997-007

District Counsel, South Texas District

Assistant Chief Counsel (Field Service) CC:DOM:FS

Significant Service Center Advice Concerning Processing Questionable Refund Cases -- False W-2's and/or Overstated Dependents and Earned Income Credit.

This responds to your request for Significant Service Center Advice dated April 8, 1997, with respect to processing 1993 tax year cases in the Questionable Refund Program. This request for advice arose as result of a visit by you to the Austin Service Center. During this visit, you were queried about whether a taxpayer's refund can be frozen and his/her tax account adjusted without any notice being sent to the taxpayer under the following scenarios: (1) where the taxpayer claims an earned income credit (EIC) to which he/she is not entitled; (2) where a fraudulent W-2, Wage and Tax Statement, is filed claiming false withholding credits to generate a refund; and (3) where there is both a fraudulent W-2 and invalid EIC claim. Tangentially, you were questioned concerning when the Internal Revenue Service (Service) can treat a return as a nullity under these scenarios.

We initially provided oral advice to you solely for the 1993 tax year. Although you specifically requested advice concerning the 1993 tax year, the analysis set forth below would also apply to other tax years, except it does not take into account the changes in law with respect to the EIC due to the enactment of the Personal Responsibility and Work Opportunity Act of 1996. Those changes affect returns, the due date of which without regard to extensions, is more than 30 days after August 22, 1996, the date of enactment of the Act.

matter with the requisite "need to know." In no event shall it be disclosed to taxpayers or their representatives.

Issues

1. When may the Service reverse tax assessments, withholding credits or the EIC claimed on a signed income tax return?

2. Whether the Service must issue a statutory notice of deficiency when disallowing EIC?

3. Whether the Service may assess an underpayment created by the disallowance of payments (withholding credits) shown on the Form W-2?

4. What should the Service do when there is both an invalid EIC claim and a fraudulent Form W-2?

Conclusions

1. If there is information from which the Service determines that the taxpayer did not sign the income tax return, then the Service may reverse any tax assessments, withholding credits or EIC claimed. However, if there is a signed return and the Service determines that it was the taxpayer who signed the return, the Service must respect that return. Even if the taxpayer signs the return, the return will not be valid when there is insufficient data to compute the tax. If the taxpayer files a return claiming false withholding credits or claiming an EIC to which the taxpayer is not entitled, but there is sufficient data to compute the tax, then the Service must respect the return. This would be so even if the withholding information were based on a false Form W-2.

2. When part or all of the EIC is disallowed, the calculation will result in a deficiency. Therefore, the Service has to send a statutory notice of deficiency when disallowing the credit. However, if a determination is made under Policy Statement 4-84 that civil enforcement may imperil the criminal investigation and prosecution of a case, then a decision may be made to delay the issuance of a statutory notice of deficiency.

3. If the Service disallowed payments (withholding credits) shown on the Form W-2, the taxpayer may be assessed under section 6201(a)(3) and the notice of assessment under section 6303(a) should be sent to the taxpayer within 60 days of assessment.

4. Where there is both an invalid EIC claim and a fraudulent Form W-2, the Service should send the notice of deficiency for the disallowed EIC and assess the disallowed

withholding credits under section 6201(a)(3). The Service would be required to send the notice of assessment under section 6303(a) for the disallowed withholding credits to the taxpayer within 60 days of assessment.

Discussion

You seek our advice concerning whether a taxpayer's refund can be frozen and his/her tax account adjusted without notice under the following scenarios: (1) where the taxpayer claims an EIC to which he/she is not entitled; (2) where a fraudulent W-2 is filed claiming false withholding credits to generate a refund; and (3) where there is both a fraudulent W-2 and invalid EIC claim. You also seek advice concerning when a return may be treated as a nullity under these scenarios.

We will first address the nullity issue. We will then address these scenarios under the factual assumption that the taxpayer actually filed and signed the tax return in question. When we initially provided oral advice to you for the 1993 tax year, we advised that statutory notices of deficiency needed to be sent by April 15, 1997. In the case of summary assessments, assessments needed to be made by April 15, 1997, and notices of assessment needed to be sent within sixty days thereafter.

Since this date has now passed, the analysis set forth below would also apply to other tax years, except it does not take into account the changes in law with respect to the EIC due to the enactment of the Personal Responsibility and Work Opportunity Act of 1996. The Service may now summarily assess additional tax due as a mathematical or clerical error for a taxpayer who claims EIC if that taxpayer fails to provide a correct taxpayer identification number or fails to pay the proper amount of self-employment tax on net earnings. The Service must provide an explanation of the adjustment and the taxpayer has 60 days to request abatement. Should the taxpayer request abatement, the Service must abate the assessment and any reassessment is subject to deficiency procedures. Those changes affect returns, the due date of which without regard to extensions, is more than 30 days after August 22, 1996, the date of enactment of the Act. If you wish for us to opine on these changes, please request in writing that we do so.

Treating Returns as a Nullity.

The Service may treat a purported return as a nullity when the return is not signed by the taxpayer or someone authorized to sign on the taxpayer's behalf. It is our understanding that there are various criminal schemes wherein returns are filed using a taxpayer's name and social security number to generate fraudulent refunds. For example, a person appropriates a

taxpayer's name and social security number and then fraudulently files a federal income tax return claiming substantial withholding credits or the EIC to generate a refund which that person intends to abscond. You asked how the Service should treat such returns.

In order to have a valid return, the taxpayer must execute that return under penalties of perjury. Beard v. Commissioner, 82 T.C. 766, 777 (1984), aff'd 793 F.2d 139 (6th Cir. 1986). Section 6064 provides that "[t]he fact that an individual's name is signed to a return, statement, or other document shall be prima facie evidence for all purposes that the return, statement, or other document was actually signed by him." Section 6064 creates the rebuttable presumption where it is presumed that the taxpayer signed the return if that taxpayer's name is signed to the return. United States v. Cashio, 420 F.2d 1132, 1135 (5th Cir. 1970). There is little doubt that a person may rationally be presumed to have signed his/her name when the name of that person has been signed to the return. United States v. Kim, 884 F.2d 189, 195 (5th Cir. 1989). This presumption gives way if there is proof that the taxpayer did not sign the return. Id. at 195 n.4. For instance, an irregularity on the return which indicates that the taxpayer did not sign the return can rebut the presumption. United States v. Borchardt, 470 F.2d 257, 261 (7th Cir. 1972).

If the Service determines that the taxpayer did not sign the return, then the Service can reverse any tax assessments, withholding credits or EIC claimed. The Service presently treats such a return as a nullity and deletes the return from master file records. However, the Service should be cautious with respect to the returns it treats as a nullity. If there is a signed return and the Service has insufficient reason to conclude that it was not the taxpayer who signed the return, then the Service must respect that return.

Even if the taxpayer signs the return, there are circumstances where the return will not be valid. For instance, a return is not a valid return when there is insufficient data to compute the tax. Joseph v. Commissioner, T.C. Memo. 1996-77. In United States v. Long, 618 F.2d 74 (9th Cir. 1980), the defendant submitted what he alleged were copies of his previously filed tax returns. The defendant inserted zeros in the spaces reserved for entering exemptions, income, tax and tax withheld. Id. at 75. The court of appeals in reversing defendant's conviction for willfully failing to file income tax returns, found that the zeros entered on the tax forms constituted information relating to the defendant's income from which the tax can be computed. The Service could calculate the assessments from the strings of zeros just as if the defendant had entered other numbers on the return. The resulting assessments might not reflect the

defendant's actual tax liability, but some computation was possible. Id.

In United States v. Kimball, 925 F.2d 356 (9th Cir. 1991), the defendant appealed his conviction for willfully failing to file income tax returns. The defendant wrote only asterisks in the space provided on the income tax forms and signed his name. The Ninth Circuit, en banc, found that defendant's 1040 forms contained no financial information whatsoever. Id. at 357. The court reasoned that nothing could be calculated from the asterisks whereas an amount could be calculated from the zeros set out on the tax forms in the Long case. Id. at 358. Both Long and Kimball unequivocally stated that a return containing false or misleading information is still a return. United States v. Long, 618 F.2d at 76; United States v. Kimball, 925 F.2d at 358. Although false figures convey false information, they do convey information. United States v. Long, 618 F.2d at 76.

Section 7206(1) further buttresses the argument that a return containing false or misleading information is still a return. That section provides that it is a crime to willfully make a false statement on a return. If false information contained on a return actually nullifies the return, then this section would be rendered meaningless.

In summary, if the taxpayer files a signed return claiming false withholding credits or claiming an EIC to which the taxpayer is not entitled, but there is sufficient data to compute the tax, then the Service must respect that return. This result would be so even if the withholding information was based on a false Form W-2, Wage and Tax Statement. A Form W-2 is a separate and distinct information return from a Form 1040.

We now turn to the issue you raised concerning what the Service should do when returns are determined not to be nullities. All the scenarios described below are answered under the assumption that the taxpayer actually filed and signed the tax return in question, and included sufficient information to compute the tax.

The Taxpayer Claims an Earned Income Credit to Which He/She is Not Entitled.

You have asked whether the Service must issue a statutory notice of deficiency when disallowing EIC. 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 notice of such deficiency to the taxpayer. Section 6213(a) provides that, in general, a taxpayer may file a petition for redetermination with the United States Tax Court within 90 days

of the mailing of the notice of deficiency. The Service is prohibited from assessing the deficiency during this 90 day period. If the taxpayer fails to file a petition with the Tax Court during this period, the Service may assess the deficiency. 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 32 provides for a credit against earned income to certain eligible individuals and is commonly referred to as the "earned income credit."

Section 6211(b)(4) provides:

> (4) For purposes of subsection (a)-
> (A) Any excess of the sum of the credits allowable under sections 32 and 34 over the tax imposed by subtitle A (determined without regard to such credits), and
> (B) any excess of the sum of such credits as shown by the taxpayer on his return over the amount shown as the tax by the taxpayer on such return (determined without regard to such credits),
> shall be taken into account as negative amounts of tax.

This language was added to the Code by section 1015(r)(2) of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA). The legislative history explained that under the law in effect prior to the Act "deficiency procedures allowing taxpayers to litigate issues in the Tax Court relating to the earned income credit (sec. 32) . . . may not apply." H.R. Rep. No. 100-795, 100th Cong., 2d Sess. 366, and S. Rep. No. 100-445, 100th Cong., 2d Sess. 387. TAMRA added new section 6211(b)(4) which "provides that the Tax Court deficiency procedures apply to credits allowable under section 32 . . . notwithstanding that the credits reduce the net tax to less than zero." H.R. Rep. No. 100-795, 100th Cong., 2d Sess. 366, and S. Rep. No. 100-445, 100th Cong., 2d Sess. 387.

The language "negative amounts of tax" means that the credit amount must be considered even if it is a negative number. When part or all of a claimed credit described in section 6211(b)(4) is disallowed, the calculation will result in a deficiency. Therefore, the Service would have to send a statutory notice of deficiency when disallowing the credit. The determination of the deficiency can be summarized by the following formula:

a) Tax shown less section 6211(b)(4) credit shown = tax on return;

b) Correct tax less correct section 6211(b)(4) credit = tax imposed;

c) Tax imposed less tax on return = deficiency.

Policy Statement 4-84 provides that when civil enforcement actions may imperil subsequent prosecution, then the consequences of the civil enforcement action upon the criminal investigation and prosecution case should be carefully weighed. Then only such actions will be taken as the Division Chiefs of the responsible field functions agree should be taken or, if agreement cannot be reached, such actions as the District Director determines shall be taken. Therefore, if a determination is made under Policy Statement 4-84 that civil enforcement may imperil subsequent prosecution, then a decision may be made to delay the issuance of a statutory notice of deficiency. If such a determination results in the issuance of the notice beyond the three year period provided for assessment in section 6501(a), it may be that the Service can rely on section 6501(c)(1) to ultimately assess the tax. Section 6501(c)(1) provides that where the taxpayer files a false or fraudulent return with intent to evade tax, then the Service may assess the taxpayer at any time. However, the burden to establish fraud falls on the Service.

It should be noted that when the Service freezes the refund, it may permit the taxpayer to satisfy the jurisdictional full payment rule set out in Flora v. United States, 362 U.S. 145 (1960). Thus, the taxpayer may be able to sue for refund in the district court or in the United States Court of Federal Claims if his/her return is not acted upon for six months after the filing of the return that also serves as a claim for refund.

In summary, when part or all of the EIC is disallowed, the calculation will result in a deficiency. Therefore, the Service has to send a statutory notice of deficiency when disallowing the credit. However, if a determination is made under Policy Statement 4-84 that civil enforcement may imperil the criminal investigation and prosecution of a case, then a decision may be made to delay the issuance of a statutory notice of deficiency.

A Fraudulent W-2 is Filed Claiming False Withholding Credits to Generate a Refund.

You have asked whether the Service may assess an underpayment created by the disallowance of payments (withholding credits) shown on the Form W-2. It should be noted that tax withheld on wages does not affect the deficiency formula. 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).

The Service derives its ability to assess additional tax due to invalid withholding credits from section 6201(a)(3). Section 6201(a)(3) provides that:

> [i]f on any return or claim for refund of income taxes under subtitle A there is an overstatement of the credit for income tax withheld at the source, or of the amount paid as estimated income tax, the amount so overstated which is allowed against the tax shown on the return or which is allowed as a credit or refund may be assessed by the Secretary in the same manner as in the case of a mathematical or clerical error appearing upon the return, except that the provisions of section 6213(b)(2) (relating to abatement of mathematical or clerical error assessment) shall not apply with regard to any assessment under this paragraph.

Section 6303(a) mandates that the Service shall, within 60 days after the making of the assessment, give notice of the assessment to the taxpayer. Thus, for an underpayment created by the disallowance of payments shown on the Form W-2 (withholding credits), the taxpayer may be assessed under section 6201(a)(3) without issuing a notice of deficiency. A notice of assessment under section 6303(a) should be sent to the taxpayer within 60 days of assessment.

In summary, if the Service disallowed payments (withholding credits) shown on the Form W-2, the taxpayer may be assessed under section 6201(a)(3) and the notice of assessment under section 6303(a) should be sent to the taxpayer within 60 days of assessment.

<u>There is Both a Fraudulent W-2 and Invalid EIC Claim.</u>

In the situation where there is both an invalid EIC claim and a fraudulent W-2, the Service should send the notice of deficiency for the disallowed earned income credit and assess the underpayment created by the disallowed withholding credits under section 6201(a)(3). The Service would be required to send the notice of assessment under section 6303(a) for the disallowed withholding credits to the taxpayer within 60 days of assessment.

_____

DEBORAH A. BUTLER