ACKNOWLEDGED SIGNIFICANT ADVICE, MAY BE DISSEMINATED

SCA 1998-042
Released 12/04/98

Internal Revenue Service

memorandum

TL-N-7963-97

date: **APR 10, 1998**

to: District Counsel, South Texas District CC:MSR:STX:AUS

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

subject: Significant Service Center Advice Concerning Disposition of Refundable Credits on Frozen Refund Cases When the Three Year Statute of Limitations for Assessment Has Expired

This responds to your request for Significant Service Center Advice dated November 12, 1997, which arose as result of a memorandum dated October 27, 1997, to your office from the Austin Service Center seeking assistance concerning how the Internal Revenue Service (Service) should treat certain overpayments of tax. Our due date was extended to April 10, 1998, to allow for thorough coordination. This advice supersedes and clarifies Service Center Advice 1997-007 that was dated June 30, 1997.

Disclosure Statement

Unless specifically marked "Acknowledged Significant Advice, May Be Disseminated" above, this memorandum is not to be circulated or disseminated except as provided in Paragraph 6 of Chief Counsel Directives Manual (35)2(13)1, and Paragraph 3(e) of Chief Counsel Directives Manual (35)2(13)4. This document may contain confidential information subject to the attorney-client and deliberative process privileges. Therefore, this document shall not be disclosed beyond the office or individual(s) who originated the question discussed herein and are working the matter with the requisite "need to know." In no event shall it be disclosed to taxpayers or their representatives.

Issues

1. How must the Service process returns on which credits are claimed based on false Form W-2s and/or overstated dependency exemptions and earned income credit (EIC)?

2. May these false or fraudulent credits be properly moved to the Excess Collections File?

3. If the Service reverses the information as reported on the return and moves the frozen refund to the "excess collections" file, is the Service required to notify the taxpayer since this is not an agreed assessment?

4. If the taxpayer asks for a refund, must the refund be

allowed?

Conclusions

1. Because the purported returns in question satisfy the criteria necessary to be considered "returns" within the meaning of I.R.C. § 6012, the **only** process by which credits to which the taxpayers are not entitled may be legally removed from the taxpayers' accounts is via assessment.

2. As stated in response to issue 1, the credits may not be properly removed from the taxpayers' accounts except by assessment. The fact that the Service has information indicating that the taxpayers are not entitled to the credits does not mean that the amounts are "excess collections" that qualify for movement into the Excess Collections File. Consequently, the Service Center may not move the credits to the Excess Collections File.

3. This question is moot because the Service is not permitted to reverse the information from the return without following assessment procedures.

4. As discussed in response to issue 1, if the assessment limitations period is open, the Service should resolve the case through assessment procedures; in the case of a false return, the assessment period never expires. Even if the assessment period does expire, taxpayers who claim credits to which they are not entitled based on false W-2s, etc., are not entitled to refunds unless they demonstrate that they did, in fact, pay an amount in excess of their correct tax liability. The period during which such taxpayers may file a refund suit to recover for their claimed overpayment will remain open indefinitely unless a notice of claim disallowance is issued, so we recommend issuing such a notice. If the overpayments are, in fact, based on false W-2s, etc., taxpayers are unlikely to file suit and would be unable to recover in any event since they will not be able to prove an overpayment.

Facts

The overpayments of tax in question arise from signed federal individual income tax returns where taxpayers have claimed payments based on false Forms W-2, Wage and Tax Statements, or where taxpayers have overstated dependency exemptions and earned income credits (EIC). These returns are identified under the Questionable Refund Program, which is designed to detect and stop fraudulent and fictitious claims for refunds. Specifically, the Service processes a return seeking a refund based on false Forms W-2 and/or overstated dependency exemptions and EIC and then freezes that refund. On some occasions the Service reverses the information from the return, thus treating the return as a nullity, or in the alternative, moves the frozen refund to excess collections, after the three year period under I.R.C. § 6501(a) expires for assessing the tax.

For example, if a determination is made under Policy Statement 4-84 that civil enforcement may imperil the criminal investigation and prosecution of the case, then a decision may be made to delay issuance of a statutory notice of deficiency. It should be noted that the initial request for advice sought answers to five questions. You agreed to withdraw your fifth question on January 22, 1998.

Discussion

1. How must the Service process returns on which credits are claimed based on false Form W-2s and/or overstated dependency exemptions and EIC?

The Internal Revenue Code has very specific requirements for filing returns, assessing tax on returns and determining deficiencies in tax so that additional assessments may be made. Section 6012 requires that certain individuals having the requisite amount of gross income file federal income tax returns. Section 6201(a)(1) provides that the Secretary shall assess all taxes determined by the taxpayer on such returns. Sections 6212-6215 impose limitations on the manner in which the Service may assess any deficiency in taxes. Once a "return" within the meaning of section 6201(a)(1) is filed, these provisions do not permit the Service to adjust a taxpayer's account without following those prescribed procedures.

A central inquiry to be answered in determining whether the Code provisions governing the processing of returns is whether the document filed by a taxpayer as a purported return is, in fact, a return for federal tax purposes. Our earlier Service Center Advice 1997-007, addressed the definition of a "return" for purposes of section 6012. That memorandum concluded that a purported return does not satisfy the criteria to be considered a section 6012 "return" if the signature on the return is forged, missing, not under penalties of perjury, or because the purported return contains insufficient information to permit the Service to compute the tax. In those narrow circumstances, the Service may treat the purported return as a nullity, reverse information from that purported return that has been entered onto the taxpayer's account and delete the return from master file records. Service Center Advice 1997-007 did not approve any systemic approach for reversing tax assessments, withholding credits or EIC claimed in other than in those narrow circumstances. Moreover, treating a purported return as a nullity is not permitted unless the Service first has sufficient factual information to determine that the taxpayer's signature is forged, etc. Sufficient factual information must be developed to determine whether the taxpayer actually signed the return. Regardless of the manner in which the information is developed, however, the Service Center may wish to consult District Counsel before taking any action on a particular return or scheme involving numerous returns. The best and most efficient administrative practice to bring certainty to the process and foreclose any due process arguments would be to

eventually issue a notice of claim disallowance even when the Service determines that the signature is forged.

In cases where signatures are not forged and the purported return otherwise meets the definition of a "return" under section 6012, treating the return as a nullity is simply not an option available to the Service. The Service cannot treat a return as a nullity merely because the return reports payments from a false Form W-2 and/or overstated dependency exemptions and EIC. The fact that entries on the return may have been incorrect or even fraudulent does not affect the fact that the documents are returns for purposes of section 6012. Zellerbach Paper Co. v. Helvering, 293 U.S. 172 (1934); Badaracco, Sr. v. Commissioner, 464 U.S. 386, 396-97 (1984) (There are numerous provisions in the Code that relate to civil and criminal penalties for submitting... false or fraudulent returns; their presence makes clear that a document which on its face plausibly purports to be in compliance, and which is signed by the taxpayer, is a return despite its inaccuracies.) Accordingly, the Service **must** process even false or fraudulent returns according to established procedures. If the Service determines that the amounts shown as due are incorrect and wishes to adjust those amounts, normal assessment procedures must be followed to correct the taxpayer's tax liability.

Applying normal assessment procedures in the case of an underpayment created by the disallowance of payments shown on a false Form W-2 (withholding credits), means that the taxpayer should be assessed under the provision of sections 6201(a)(3). A notice of assessment under section 6303(a) must be sent to the taxpayer within 60 days of assessment. Such an adjustment is not an assessment of a "deficiency."

For the disallowance of dependency exemptions and EIC shown on the return, the Service **must** follow deficiency procedures and issue a statutory notice of deficiency. The only exception would be where the disallowance becomes immediately assessable under I.R.C. § 6213(b)(1) as a "mathematical or clerical error." Section 6213(g)(2) sets out the various types of factual situations which will fall within the term "mathematical or clerical error" and includes the omission on the return of the correct taxpayer identification number required by section 32. If there is both a fraudulent Form W-2, creating an overstatement as described in section 6201(a)(3), and the taxpayer claims dependency exemptions and EIC to which the taxpayer is not entitled, the Service must send a notice of deficiency for the disallowed dependency exemptions and EIC (unless they are considered "mathematical or clerical errors") and assess the underpayment created by the disallowed withholding credits under section 6201(a)(3). If there is both a mathematical error and an adjustment requiring a statutory notice of deficiency, a statutory notice of deficiency encompassing both the math error

and the other adjustment must be sent to the taxpayer, rather than a math error notice and a statutory notice of deficiency.[1]

It is our understanding that in the cases for which you requested advice, normal assessment procedures were not followed. No assessments were made and no notices of deficiency or math error notices were sent to the taxpayers. In some instances, the normal period of limitations on assessment has expired. In such cases, there is no authority which would allow the Service to adjust the amounts reported on the taxpayers' returns, unless the Service determines that the returns in question are fraudulent. If fraudulent, statutory notices of deficiency can still be sent since there is an unlimited statute of limitations on assessment where the deficiencies are due to fraud. Section 6501(c). Of course, with respect to returns from calendar years 1994 and later, the statute of limitations on assessment remains open and the Service should make math error assessments or send notices of deficiency as appropriate.

As we previously stated, a decision to delay the issuance of a statutory notice of deficiency happens in some instances where a determination is made under Policy Statement 4-84. Policy Statement 4-84 provides that when a civil enforcement may imperil subsequent prosecution, then the consequences of the civil enforcement action upon the criminal investigation and prosecution of the 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, then a decision may be made to delay the issuance of a statutory notice of deficiency.

2. May these false or fraudulent credits be properly moved to the Excess Collections File?

The excess collections file is a file within the Integrated Data Retrieval System (IDRS) containing non-revenue receipts which cannot be identified or applied. IRM 3(17)10.1.3, SC and NCC Accounting and Data Control. Amounts from time barred claims for refund are moved to the excess collections file. As will be discussed in the answer to Question 4, there are not yet any time barred refunds in the cases discussed herein. Thus, the amounts at issue do not fall within the description of the Excess Collections File provided in IRM 3(17)(58) and it is

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[1] While an assessment under section 6201(a)(3) may be assessed in the same manner as a mathematical or clerical error appearing on a return, assessments under section 6201(a)(3) are not technically considered "mathematical or clerical errors" as that term is described in section 6213(g)(2), and are not subject to abatement at taxpayer request.

inappropriate to transfer the credits to that account. The amounts in question can only be transferred to the excess collection file after the appropriate refund disallowance procedures have been followed and the taxpayer has failed to file suit. Of course if a statutory notice of deficiency is issued and the taxpayer defaults or if the taxpayer fails to appropriately challenge a notice of math error correction, the amounts must be applied to the assessments and no excess collections result.

3. If the Service reverses the information as reported on the return and moves the frozen refund to the "excess collections" file, is the Service required to notify the taxpayer since this is not an agreed assessment?

Because the Service cannot reverse the information as reported on the return without following statutory notice or math error notice procedures, i.e., notifying taxpayers, this question is moot.

4. If the taxpayer asked for a refund, should the refund be allowed?

The original return serves as a timely claim for refund. Treas. Reg. § 301.6402-3(a)(5). Consequently, taxpayers who file returns reporting an overpayment have asked for a refund. If the Service sends the taxpayer a notice of claim disallowance, the taxpayer will have two years to file a refund suit. Section 6532(a). Until a notice of claim disallowance is sent, the period of limitations on filing suit for refund remains open.

Of course, the fact that a taxpayer claims a refund of a purported overpayment does not mean that a refund must be paid. It is the actual payment of amounts in excess of the taxpayer's correct tax liability, not the reporting of an overpayment, that gives rise to a right to a refund. Nor do the amounts shown as overpayments on the taxpayers' returns become overpayments if the period of limitations on assessment expires without assessment of additional tax greater than or equal to the purported overpayment. So long as the alleged payments in excess of the assessed liabilities were made prior to the expiration of the period of limitations on assessment, the expiration of that period will not automatically entitle a taxpayer to a refund. Rev. Rul. 85-67, 1985-1 C.B. 364; Moran v. United States, 63 F.3d 663 (7th Cir. 1995); Ewing v. Commissioner, 914 F.2d 499 (4th Cir. 1990). Taxpayers who claim a refund must demonstrate that they actually overpaid their correct tax liability. Lewis v. Reynolds, 284 U.S. 281 (1932). The Service may, therefore, determine whether to refund the claimed overpayments based on the merits of the claim, i.e., a consideration of whether the taxpayers have as much withholding as reported, as many dependents as claimed or meet the requirements for the EIC.

We caution that the right of the Service to insist that taxpayers demonstrate an actual overpayment should not be used as the basis for perpetually "freezing" refunds. Counsel recommends that the 6 month period set out in section 6532(a), which is the earliest period the taxpayer can commence refund litigation, should be used as a guideline for the length of time a requested refund should be frozen. As soon as is reasonable, the Service should either issue a notice of claim disallowance or issue a statutory notice to allow the taxpayer to challenge the Service's action.

Note that substantially the same policies and standards governing the extent of examination, evaluation of evidence, issuance of preliminary letters and referral of cases to an Appeals Office apply to cases involving claims for refund considered on their merits as would be applicable in comparable cases not involving claims. See Policy Statement 4-75; Treas. Reg. § 601.105(e)(2).

/s/

DEBORAH A. BUTLER