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

OFFICE OF
CHIEF COUNSEL

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MEMORANDUM FOR DISTRICT COUNSEL, PENNSYLVANIA DISTRICT, PHILADELPHIA

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

SUBJECT: Significant Service Center Advice

This responds to your request for Significant Advice dated November 24, 1998, in connection with a question posed by the Philadelphia Service Center.

ISSUE(S):

1. May Service Centers prepare proper income tax returns from the improper returns that taxpayers file with the Service?

2. May the Service assess tax liability based on the returns it prepares without following the statutory notice of deficiency procedures under I.R.C. §§ 6212 and 6213?

CONCLUSION:

1. To the extent that a form submitted by a taxpayer is signed under penalty of perjury and contains sufficient data to calculate the tax liability of the taxpayer, the form constitutes a return, notwithstanding that the form is unpostable under Service Center procedures. The Service may process these returns by transferring line item information to other forms that are postable, but the postable forms created do not constitute the taxpayers' returns. The forms that the Service Center fills out will be merely the mechanism by which the returns submitted on incorrect forms are processed.

2. When a taxpayer does not calculate its tax liability on the return it submits via an inappropriate form, the Service Center may not assess tax liability without following deficiency procedures specified under I.R.C. §§ 6212 and 6213.

FACTS:

The Philadelphia Service Center has a recurring problem with taxpayers who have not elected S corporation status and incorrectly file Forms 1120S. Conversely, taxpayers who have properly elected S corporation status sometimes file Forms 1120. Although the Service Center attempts to contact these taxpayers and have them file the correct income tax return forms, a large percentage (80%) do not respond to the Service Center's contacts.

In the case of nonresponsive taxpayers, the incorrect tax forms and related information are considered unpostable. Therefore, the income tax returns are not processed, potential tax assessments are not being made and tax revenue is lost. Further, this problem consumes significant staff hours and resources.

The Service Center proposes transferring line item amounts from the incorrect income tax return forms to return forms that reflect the taxpayers' proper status. The Service Center would then process the correct forms and assess any resulting tax liability.

LAW AND ANALYSIS

THE INCORRECT FORMS THAT PROVIDE SUFFICIENT DATA TO CALCULATE TAX LIABILITY CONSTITUTE RETURNS

The questions the Service Center raises presume that when a taxpayer files an incorrect form, then that form does not constitute a valid return. This presumption is incorrect. A document, even if on an incorrect form, need meet only four criteria to qualify as a valid return.

> First, there must be sufficient data to calculate tax liability; second, the document must purport to be a return; third, there must be an honest and reasonable attempt to satisfy the requirements of the tax law; and fourth, the taxpayer must execute the return under penalties of perjury.

Beard v. Commissioner, 82 T.C. 766, 777 (1984), aff'd per curiam, 793 F.2d 139 (6th Cir. 1986). Apparently, the incorrect forms in question meet all the foregoing criteria.

If a Form 1120S is submitted when a Form 1120 is the correct form and the Service Center can process the Form 1120S by transcribing the information thereon to the proper Form 1120, then the incorrect Form 1120S must contain sufficient data to calculate the taxpayer's tax liability. Thus, the first criterion of the Beard test is satisfied in such situations. Furthermore, if a Form 1120 is filed when a Form

1120S is appropriate, it appears that there would generally be no impediment to calculating the tax liability of the Subchapter S corporation filing the form. In general, because Subchapter S corporations are passthrough entities, the corporation would usually owe no tax. The Form 1120 may provide insufficient data to identify the taxpayers to whom taxable income will flow through, but such a shortcoming will not affect the liability of the Subchapter S corporation.

It further appears that there is no question about whether incorrect Forms 1120 and 1120S satisfy the three remaining criteria of Beard. Such forms purport to be returns. They appear to be honest and reasonable attempts to satisfy the tax law. And the forms both have jurat provisions whereby taxpayers execute the forms under penalties of perjury.

The opinion of the Supreme Court in Germantown Trust Co., Trustee v. Commissioner, 309 U.S. 304 (1940), further bolsters the conclusion that the use of an incorrect Form 1120S for a Form 1120, or vice versa, does not render the Form an invalid return. In Germantown, the plaintiff, a mutual fund company, paid to participants in its mutual fund their respective shares of income from invested principal and filed fiduciary returns of income on Treasury Form 1041, a form intended for use by trustees. The return accurately set forth gross income, deductions, and net income (i.e., all the information necessary to calculate any tax due) and attached a list of the beneficiaries of the fund, and their shares of the income. Subsequently, the Service determined that the fund should be taxed as a corporation. It used the Form 1041 to prepare a substitute corporate return on Form 1120, and gave notice of a consequent deficiency of tax. When the taxpayer sued and asserted that the statute of limitations on assessment of the claimed deficiency had expired, the Service contended that the Form 1041 did not constitute a corporate return and, thus, it did not trigger the limitations statute there at issue. The Supreme Court rejected this contention noting that the return had been filed in good faith and that it disclosed all the data from which the tax could be computed. Although the return failed to compute a tax, the court found that defect to fall short of rendering it no return at all.

Likewise, here, when a taxpayer who should file a Form 1120 files a Form 1120S and does not compute its corporate tax due, it appears that the Forms 1120S submitted to the Service Center contain sufficient information to compute the appropriate tax. Thus, the Service should treat the incorrect forms as the returns of the taxpayers.[1] Germantown, supra.

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[1] Such treatment will guard against the unwitting expiration of the statute of limitations on assessment, which is triggered by the filing of a return. See I.R.C. § 6501.

Of course, the Service may use the information submitted by the taxpayer to complete a form other than the one submitted if such a step is needed to process the return. The form the Service prepares, however, will not constitute the taxpayer's return or a substitute for return. Under I.R.C. § 6020(b), the Service has authority to prepare and execute substitutes for returns only if a person fails to make a return. Because we conclude that the use of a Form 1120 for a Form 1120S, or vice versa, does not constitute a failure to make a return, the requisite conditions to invoke the authority of I.R.C. § 6020(b) do not exist.

## THE SERVICE MUST FOLLOW DEFICIENCY PROCEDURES

We also conclude that, when a taxpayer submits a return on an inappropriate form and does not calculate its tax liability, the Service Center may not assess liability on the basis of the returns without following deficiency procedures specified under I.R.C. §§ 6212 and 6213.[2] Of course, the deficiency procedures apply if there is a deficiency as defined in I.R.C. § 6211. That section defines a deficiency to be the amount by the which the tax imposed exceeds the sum of the amount of tax shown on the return and the amount of tax previously assessed over any rebates. In the typical case where there is no amount previously assessed or rebate involved, the pertinent definition of deficiency is the amount by which the tax imposed exceeds "the amount shown as the tax by the taxpayer upon his return." I.R.C. § 6211(a). If the taxpayer has not computed his tax on a submitted return (as would be the case with a Form 1120S filed where a Form 1120 was appropriate), there would be no "amount shown as the tax by the taxpayer upon his return."[3]

Moreover, we do not believe that the Service's calculation of the tax due on the basis of figures appearing on an inappropriate form can be treated as the equivalent of the "amount shown as the tax by the taxpayer upon his return." I.R.C. § 6211(b)(3) provides that "the computation by the [Service], pursuant to section 6014, . . . shall be considered as having been made by the taxpayer and the tax so computed considered as shown by the taxpayer upon his return." By implication,

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[2] We note that TEFRA procedures, rather than ordinary deficiency procedures, governed subchapter S corporations for taxable years beginning after December 31, 1982, and before January 1, 1997.

[3] When a Form 1120 is filed where a Form 1120S is appropriate, the proper amount of tax should be generally be zero because Subchapter S corporations are usually not liable for tax. Thus, ordinarily, there would be no tax to assess against the corporation. Of course, any derivative tax liability of the shareholders of the corporation should be reflected on the returns of the individual shareholders and assessments may not be made against the individual shareholders on the sole basis of information reported on the corporation's return.

this provision excludes such treatment being accorded to computations other than those pursuant to section 6014. Section 6014 provides for taxpayers to elect affirmatively to have the Service compute their taxes when certain qualifying criteria apply. On the forms in question, there is no provision for taxpayers to make such an election. Accordingly, we believe that assessment on the basis of inappropriate Forms 1120 or 1120S submitted by taxpayers should not be made absent the use of deficiency procedures.[4]

If you have any further questions, please call the branch telephone number.

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By: /s/
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[4] Note that I.R.C. § 6213(b)(4) provides that any amount paid as a tax or in respect of a tax may be assessed upon the receipt of such payment. Thus, if a payment accompanied a Form 1120S that a corporation filed when a Form 1120 was appropriate and the Service determined that the corporation owed tax, it could assess tax in the amount of the payment under the authority of § 6213(b)(4) without following usual deficiency procedures.