Office of Chief Counsel
Internal Revenue Service

memorandum

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from: James C. Gibbons, Chief
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subject: Horse's Tax Service, POSTN-123371-03

This Memorandum responds to your e-mail to George Bowden dated March 26, 2003. In accordance with I.R.C. § 6110(k)(3), this Memorandum is not to be used or cited as precedent.

Issues

1. Is a return a nullity if a return preparer increased the charitable contribution amount on a taxpayer's return to inflate a refund, and the taxpayer was unaware of the increased charitable contribution and did not benefit from that part of the refund?

2. If a return is a nullity but the taxpayer received a refund anticipation loan for the correct amount of his refund (minus normal preparation fees), does the taxpayer receive another refund when his true return is filed?

3. Is a return a nullity if a taxpayer willingly allowed the preparer to add fraudulent expenses to his Schedule C to gain a larger refund, but the preparer also increased the charitable contribution amount on the Schedule A, and the taxpayer was unaware of the inflated charitable contribution amount and doesn't benefit from that part of the refund associated with the inflated charitable contribution?

4. In both situations, should the taxpayer correct his account by filing a new return or an amended return?

5. SBSE has agreed to audit [redacted] of these Schedule C's. Is this the best way to handle these fraudulent returns?

Conclusions

1. The return is a nullity because what was sent to the Internal Revenue Service (Service) is a document unknown and unverified by the taxpayer.

2. Assuming that the taxpayer had received the correct amount based on his withholding and tax liability, there is no overpayment, and the Service should not issue a second refund to the taxpayer. Where the taxpayer sent the refund amount to the financial institution because the Service has frozen the refund, however, there is an overpayment and no unjust enrichment. In this situation, the Service should send the correct amount of refund directly to the taxpayer.

3. As in Issue 1, the return is a nullity because what was sent to the Service is a document unknown and unverified by the taxpayer.

4. The taxpayer's Master File account should be corrected by having the taxpayer whose return has been fraudulently altered by the return preparer file an accurate Form 1040 or 1040 series return from which Criminal Investigation or the SBSE Division can adjust the Master File account to reflect the correct information. The taxpayer should not file a Form 1040X because the electronic return and Form 8453 filed by the preparer are nullities and no return has been filed by the taxpayer.

5. The assignment of the SBSE division to audit a percentage of the Schedule C returns is a business decision that should be made by the Campus and the Operating Divisions.

Facts

Your e-mail presents the following scenario for analysis. Horse (this name has been changed for confidentiality purposes) is a certified public accountant preparing individual income tax returns. Horse prepared approximately [redacted] returns for tax year [redacted] of which, approximately [redacted] were filed electronically with the Service. Horse prepared tax returns with the information provided by the client and printed a copy of that return to give to the client. Horse established a refund anticipation loan (RAL) account at a financial institution for that client that allowed him to issue a bank check prior to the refund being received from the IRS. Prior to transmitting the return to the Service, Horse increased the charitable contribution amount on the Schedule A without his client's knowledge in order to increase the refund received from the Service. Horse provided his client with the copy of the return printed earlier, which *did not* contain the inflated charitable contributions, and a bank check for the amount of the refund on that tax return less his [$ redacted] preparation fee.

Once the Service received the electronic return, the refund was wired to the financial institution. The financial institution then paid off the client's RAL account, deducted the RAL and bank fees, and as instructed by Horse, placed the remainder of the refund into

Horse's preparer account as preparer fees. Once these fees reached Horse's preparer account at the financial institution, the fees were automatically wired to Horse's checking account.

It does not appear that any of Horse's clients were aware that Horse was increasing the charitable contribution amounts on their returns. It also appears that none of Horse's clients knew that RAL accounts were being created in their names at the financial institution.

In some cases, the Service froze the refunds and did not send the refund amounts to the financial institution. In those case, the financial institution made demand to the taxpayers for the refund amounts. Many of these taxpayers paid the financial institution the amount of the check they received, and many paid the entire amount of the RAL including the fraudulent portion that Horse received without their knowledge. The taxpayers were completely unaware that they were receiving RALs and that their refunds were routed through the financial institution.

Evidence obtained from Horse's computer and witnesses' testimony show that Horse also reported fraudulent Schedule C business expenses for several of his clients. Horse reported legal and professional fees paid to him on these Schedule Cs which in fact were never paid, and generated fraudulent invoices for expenses never paid by the Schedule C businesses. It appears that these fraudulent expenses were created *with* the clients knowledge.

Law and Analysis

Issue 1: Is a return a nullity if a return preparer increased the charitable contribution amount on a taxpayer's return to inflate a refund, and the taxpayer was unaware of the increased charitable contribution and did not benefit from that part of the refund?

The return is a nullity because the electronic file submitted to the Service is a document unknown and unverified by the taxpayer. Courts have identified a four-part test for determining whether a defective or incomplete document is 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). This generally accepted formulation of the criteria for determining a valid return, known as the *Beard* formulation or the "substantial compliance" standard, derives from a venerable line of Supreme Court cases. *Zellerbach Paper Co. v. Helvering*, 293 U.S. 172, 180 (1934); *Badaracco v. Commissioner*, 464 U.S. 386 (1984); *Florsheim Bros. Drygoods Co v. United States*, 280 U.S. 453 (1930).

The signature requirement derives from I.R.C. § 6065 which provides that generally, any return, declaration, statement, or other document required to be made under any provision of the internal revenue laws or regulations shall contain or be verified by a written declaration that it is made under penalties of perjury. The purpose of this requirement is to authenticate the signed document, and to verify its truthfulness.

Line 4 of Part 1 of the Form 8453 reports the amount of a taxpayer's refund. The Jurat portion of Form 8453 provides:

> Under penalties of perjury, I declare that the information I have given my ERO and the amounts in part 1 above agree with the amounts on the corresponding lines of the electronic portion of my [year] Federal income tax return. To the best of my knowledge and belief, my return is true, correct and complete.

In cases where the taxpayer is unaware of fraudulent inflated charitable contribution expenses added by the return preparer, it cannot be said that the taxpayer executed his return under penalties of perjury, because what was submitted to the Service by the preparer is not the document signed by the taxpayer. Here the taxpayer signed and verified a return that was not sent to the Service. Accordingly, the electronic file and Form 8453 fail to meet the signature requirement set forth in *Beard*, fail to meet the substantial compliance standard, and is not a return. Since the document does not constitute a return, it has no status under the Internal Revenue Code and is a nullity. Because no return has been filed, under I.R.C. § 6664(b), no accuracy related or civil fraud penalties can be imposed against the taxpayer. However, criminal fraud penalties under I.R.C. §7206 may apply.

Issue 2: If a return is a nullity but the taxpayer received a refund anticipation loan for the correct amount of his refund (minus normal preparation fees), does the taxpayer receive another refund when his true return is filed?

The taxpayer should not be entitled to a refund from the Service when he has received through the preparer the amount to which he was in fact entitled. This is because there is no overpayment. No refund can be made unless it has first been determined that the taxpayer has made an overpayment in tax for the year. In *Jones v. Liberty Glass Co.*, 332 U.S. 524, 531 (1947), the Supreme Court defined the term overpayment broadly and colloquially, stating:

> [W]e read the term "overpayment" in its usual sense, as meaning any payment in excess of that which is properly due. Such an excess payment may be traced to an error in mathematics or in judgment or in interpretation of facts or law. And the error may be committed by the taxpayer or by the revenue agents. Whatever the reason, the payment of more than is rightfully due is what characterizes an overpayment.

Thus, assuming that the taxpayer had received the correct amount based on his withholding and tax liability, there is no overpayment, and the Service should not issue a second refund to the taxpayer. In addition, any second payment to the taxpayer would result in the taxpayer's unjust enrichment. Where the taxpayer sent the refund amount to the financial institution because the Service has frozen the refund, however, there is an overpayment and no unjust enrichment. In this situation, the Service should send the taxpayer the correct amount of refund. Since the taxpayer was completely unaware that he was receiving RALs and that the refunds were routed through the financial institution, the Service should send the refund directly to the taxpayer and not forward the refund through the financial institution.

Issue 3: Is a return a nullity if a taxpayer willingly allowed the preparer to add fraudulent expenses to his Schedule C to gain a larger refund, but the preparer also increased the charitable contribution expense on the Schedule A, and the taxpayer was unaware of the inflated charitable contribution expense and doesn't benefit from that part of the refund associated with the inflated charitable contribution?

Even though the taxpayer was aware of and consented to the fraudulent inflation of the Schedule C expenses, the taxpayer was not aware of the addition of the charitable contribution. Using the same rationale in issue 1, the taxpayer has signed and verified documents that was not sent to the Service. What was sent to the Service is a document unknown and unverified by the taxpayer. Accordingly, the electronic file and Form 8453 fail to meet the signature requirement set forth in *Beard*, fail to meet the substantial compliance standard, and are not returns. As discussed above, although criminal fraud penalties under I.R.C. §7206 may apply, no accuracy related or civil fraud penalties can be imposed against the taxpayer pursuant to I.R.C. § 6664(b) because no return has been filed.

Issue 4. In both situations, should the taxpayers correct their account by filing new returns or amended returns?

The taxpayer's Master File account should be corrected by having the taxpayer whose return has been fraudulently altered by the return preparer file an accurate Form 1040 or 1040 series return from which Criminal Investigation or the SBSE Division can adjust the Master File account to reflect the correct information. The taxpayer should not file a Form 1040X because the electronic return and Form 8453 filed by the preparer are nullities and no return has been filed by the taxpayer.

Issue 5. SBSE has agreed to audit 50-100 of these Schedule C's. Is this the best way to handle these fraudulent returns?

The assignment of the SBSE division to audit a percentage of the Schedule C returns is a business decision that should be made by the Campus and the Operating Divisions. We note, however, that because no return has been filed in these cases, under I.R.C.

§ 6664(b), no accuracy related or civil fraud penalties can be imposed against the taxpayer. We also note that IRM section 4.10.6.3.3(2) (05-14-1999) provides that "when a potential criminal fraud case is identified, preparation of a timely fraud referral to Criminal Investigation is necessary pursuant to the provisions of IRM 25.1, Fraud." See also IRM section 5.1.11.6, Referrals to Criminal Investigation (05-27-1999).

If you have any questions, please contact this office at (202) 622-4910.