

Office of Chief Counsel
Internal Revenue Service

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memorandum

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to: District Counsel, Brooklyn CC:NER:BRK
Attn: Patricia Riegger

from: Assistant Chief Counsel CC:DOM:IT&A
(Income Tax and Accounting)

subject: Significant Service Center Advice - Fraud Penalty Based On
Earned Income Credit

In a memorandum dated January 23, 1998, this office responded to your undated request for Significant Advice (forwarded by an electronic mail message dated September 26, 1997) in connection with questions posed by the Civil Fraud Coordinator, Examination Division, of the Brookhaven Service Center. This memorandum supersedes our January 23, 1998, memorandum with respect to Issue 3. As explained below, we still agree with the conclusions reached in your request for Significant Advice. However, by this memorandum, this office is adopting a different rationale for the conclusion reached in respect to Issue 3.

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 CCDM (35)2(13)3:(4)(d) and (35)2(13)4:(1)(e). 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 questions 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. Does the disallowance of an earned income credit (EIC) under § 32 of the Internal Revenue Code result in a statutory deficiency?

2. May the civil fraud penalty under § 6663 of the Code be asserted when a fraudulent EIC claim is made?

3. Assuming the civil fraud penalty under § 6663 can be asserted when a fraudulent EIC claim is made, how is the amount

of the underpayment determined when the correct tax is zero and the Service has not issued a refund of the falsely claimed EIC? How is the amount of the underpayment determined when the Service has issued a refund?

Conclusions

1. Based on the facts described below, the disallowance of an EIC results in a statutory deficiency.

2. Based on the facts described below, the civil fraud penalty under § 6663 may be asserted when a fraudulent EIC claim is made if there is an underpayment of tax attributable to fraud.

3. Based on the facts described below, the underpayment of tax for purposes of calculating the civil fraud penalty is determined under the formula prescribed in § 6664 and the regulations thereunder. Under that formula, the EIC under § 32 may be taken into account as a negative amount of tax in a manner consistent with the rules provided in § 6211(b)(4). However, there cannot be an underpayment attributable to a fraudulently claimed EIC if the Service has not issued a refund.

Facts

The Service Center has received numerous Form 1040 series returns that appear to have a pattern of falsely claimed items of income and deductions in order to falsely obtain refunds of the EIC. In a typical scenario, a taxpayer, previously a non-filer, files a timely 1996 return and delinquent returns for 1995, 1994, and 1993. On each return, the taxpayer falsely reports earned income that is reduced by the standard deduction and sufficient exemptions to eliminate any tax due. (Sometimes a taxpayer will report self-employment tax with respect to the earned income attributable to self-employment income.) The taxpayer also falsely claims the EIC. The taxpayer does not claim any credits for withholding or estimated tax payments. It appears that the correct tax is zero (including self-employment tax) and the correct EIC is zero.

Discussion

1. Does the disallowance of an EIC under § 32 of the Code result in a statutory deficiency?

Section 32 provides for the EIC. Section 6211(a) defines a "deficiency" as follows:

(a) IN GENERAL.--For purposes of this title in the case of income, estate, and gift taxes imposed by subtitles A and

B and excise taxes imposed by chapters 41, 42, 43, and 44 the term "deficiency" means the amount by which the tax imposed by subtitle A or B, or chapter 41, 42, 43, or 44 exceeds the excess of--

(1) the sum of

(A) the amount shown as the tax by the taxpayer upon his return, if a return was made by the taxpayer and an amount was shown as the tax by the taxpayer thereon, plus

(B) the amounts previously assessed (or collected without assessment) as a deficiency, over--

(2) the amount of rebates, as defined in subsection (b)(2), made.

For purposes of determining the amount of a deficiency, § 6211(b)(4) provides that the EIC is treated as a negative tax. Section 6211(b)(4) states:

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.

The statutory requirements can be summarized by the following formulas:

- a) Tax shown less EIC shown = tax on return
- b) Correct tax less correct EIC = tax imposed
- c) Tax imposed less tax on return = deficiency

Within your request for Significant Advice, you provided two examples that are correct applications of § 6211. In the first general example, the correct tax is \$1,000, the correct EIC is zero, the taxpayer shows no tax on the return, and the taxpayer

claims a \$500 EIC. A deficiency is computed using the formulas, as follows:

a)	Tax shown	0
	<u>Less EIC shown</u>	<u>500</u>
	Tax shown on return	(500)
b)	Correct tax	1,000
	<u>Less correct EIC</u>	<u>0</u>
	Tax imposed	1,000
c)	Tax imposed	1,000
	<u>Less tax on return</u>	<u>(500)</u>
	Deficiency	1,500

In the second example (applicable to the cases under consideration), the correct tax is zero (including self-employment tax), the correct EIC is zero, the taxpayer shows no tax on the return (including self-employment tax), and the taxpayer falsely claims a \$500 refund solely attributable to the EIC. The deficiency would be computed as follows:

a)	Tax shown	0
	<u>Less EIC shown</u>	<u>500</u>
	Tax shown on return	(500)
b)	Correct tax	0
	<u>Less correct EIC</u>	<u>0</u>
	Tax imposed	0
c)	Tax imposed	0
	<u>Less tax on return</u>	<u>(500)</u>
	Deficiency	500

We note that § 6213(b) provides exceptions to the restrictions on making assessments, one of which is for assessments arising out of mathematical or clerical errors. With respect to taxpayers who do not report self-employment tax with respect to the earned income attributable to self-employment income, you should be aware that § 6213(g)(2)(G) provides that a mathematical or clerical error includes an entry on a return claiming the credit under § 32 with respect to net earnings from self-employment described in § 32(c)(2)(A) to the extent the tax imposed by § 1401 (relating to self-employment tax) on such net earnings has not been paid. This provision applies with respect to returns the due date for which (without regard to extensions) is more than 30 days after August 22, 1996.

2. May the civil fraud penalty under § 6663 of the Code be asserted when a fraudulent EIC claim is made?

Section 6663(a) provides that if any part of any underpayment of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 75 percent of the portion of the underpayment which is attributable to fraud.

We see no reason why the civil fraud penalty under § 6663 should not apply to a falsely claimed EIC if it causes an underpayment as defined in § 6664 or the formula prescribed in § 1.6664-2 of the Income Tax Regulations.

3. Assuming the civil fraud penalty under § 6663 can be asserted when a fraudulent EIC claim is made, how is the amount of the underpayment determined when the correct tax is zero and the Service has not issued a refund of the falsely claimed EIC? How is the amount of the underpayment determined when the Service has issued a refund?

Section 6664(a) provides that, for purposes of this part (which includes § 6663(a)), the term "underpayment" means the amount by which any tax imposed by this title (Title 26-Internal Revenue Code) exceeds the excess of:

(1) the sum of--

(A) the amount shown as the tax by the taxpayer on his return, plus

(B) amounts not so shown previously assessed (or collected without assessment), over

(2) the amount of rebates made.

For purposes of paragraph (2), the term "rebate" means so much of an abatement, credit, refund, or other repayment, as was made on the ground that tax imposed was less than the excess of the amount specified in paragraph (1) over the rebates previously made.

Section 1.6664-2(a) provides, in part, that an underpayment for purposes of § 6663 means the amount by which any income tax imposed under subtitle A (as defined in § 1.6664-2(b)) exceeds the excess of:

(1) the sum of--

(i) the amount shown as the tax by the taxpayer on his return (as defined in § 1.6664-2(c)), plus

(ii) amounts not so shown previously assessed (or collected without assessment) (as defined in § 1.6664-2(d)), over

(2) the amount of rebates made (as defined in § 1.6664-2(e)).

The regulations also provide that the definition of underpayment also may be expressed by the following equation:

$$\text{Underpayment} = W - (X + Y - Z)$$

- W = the amount of income tax imposed
- X = the amount shown as the tax by the taxpayer on his return
- Y = amounts not so shown previously assessed (or collected without assessment)
- Z = the amount of rebates made

Section 1.6664-2(b) provides that the "amount of income tax imposed" is the amount of tax imposed on the taxpayer under subtitle A for the taxable year, determined without regard to:

- (1) the credits for tax withheld under §§ 31 (relating to tax withheld on wages) and 33 (relating to tax withheld at source on nonresident aliens and foreign corporations);
- (2) payments of tax or estimated tax by the taxpayer;
- (3) any credit resulting from the collection of amounts assessed under § 6851 as the result of a termination assessment, or § 6861 as the result of a jeopardy assessment; and
- (4) any tax that the taxpayer is not required to assess on the return (such as the tax imposed by § 531 on the accumulated taxable income of a corporation).

Section 1.6664-2(c)(1) defines the "amount shown as the tax by the taxpayer on his return" as the tax liability shown by the taxpayer on his return, determined without regard to the items listed in § 1.6664-2(b)(1), (2), and (3), except that it is reduced by the excess of:

- (i) the amounts shown by the taxpayer on his return as credits for tax withheld under § 31 (relating to tax withheld on wages) and § 33 (relating to tax withheld at source on nonresident aliens and foreign corporations), as payments of estimated tax, or as any other payments made by the taxpayer with respect to a taxable year before filing the return for such taxable year, over
- (ii) the amounts actually withheld, actually paid as estimated tax, or actually paid with respect to a taxable year before the return is filed for such taxable year.

Section 1.6664-2(d) provides that "amounts not so shown previously assessed" means only amounts assessed before the return is filed that were not shown on the return, such as termination assessments under § 6851 and jeopardy assessments under § 6861 made prior to the filing of the return for the taxable year. The amount "collected without assessment" is the amount by which the total of the credits allowable under § 31 (relating to tax withheld on wages) and § 33 (relating to tax withheld at source on nonresident aliens and foreign corporations), estimated tax payments, and other payments in

satisfaction of tax liability made before the return is filed, exceed the tax shown on the return (provided such excess has not been refunded or allowed as a credit to the taxpayer).

Section 1.6664-2(e) defines "rebate" as so much of an abatement, credit, refund, or other repayment, as was made on the ground that the tax imposed was less than the excess of:

- (1) the sum of--
 - (i) the amount shown as the tax by the taxpayer on his return, plus
 - (ii) amounts not so shown previously assessed (or collected without assessment), over
- (2) rebates previously made.

Example 3 of § 1.6664-2(g) shows how to calculate the amount of underpayment in a situation involving overstated estimated tax payments. On Form 1040 filed for tax year 1990, taxpayer correctly reported a tax liability of \$10,000 and incorrectly reported estimated tax payments of \$15,000. Taxpayer received a refund of \$5,000. The correct amount of estimated tax payments was only \$7,000. For purposes of determining the amount of the underpayment subject to a penalty under § 6662 or § 6663, the tax shown on the is \$2,000 (reported tax liability of \$10,000 reduced by the overstated estimated tax of \$8,000 (\$15,000 minus \$7,000)). The underpayment is \$8,000 determined as follows:

Tax imposed under subtitle A		\$10,000
Tax shown on return	\$2,000	
Tax previously assessed (or collected without assessment)	None	
Amount of rebates made	<u>None</u>	
Balance		<u>\$2,000</u>
Underpayment		\$8,000

If the facts of Example 3 were the same except that no refund was made, the underpayment would be \$3,000, determined as follows:

Tax imposed under subtitle A		\$10,000
Tax shown on return	\$2,000	
Tax previously assessed (or collected without assessment)	\$5,000	
Amount of rebates made	<u>None</u>	
Balance		<u>\$7,000</u>
Underpayment		\$3,000

In this situation, the amount "collected without assessment" is \$5,000 (\$7,000 minus \$2,000). The amount of the total of the

credits allowable under § 31 and § 33, estimated tax payments, and other payments in satisfaction of tax liability made before the return is filed is \$7,000. The tax shown on the return is \$2,000. For purposes of § 1.6664-2(d), the term "tax shown on the return" must be interpreted as equivalent to the "amount shown as the tax by the taxpayer on his return" in order for the formula to produce the correct result.

Section 6211 provides that for purposes of title 26 in the case of income, estate, and gift taxes imposed by subtitles A and B and excise taxes imposed by chapters 41, 42, 43, or 44 the term "deficiency" means the amount by which the tax imposed by subtitle A or B, or chapter 41, 42, 43, or 44 exceeds the excess of---

(1) the sum of

(A) the amount shown as the tax by the taxpayer upon his return, if a return was made by the taxpayer and an amount was shown by the taxpayer thereon, plus

(B) the amounts previously assessed (or collected without assessment) as a deficiency, over---

(2) the amount of rebates, as defined in subsection (b)(2), made.

Section 6211(b)(4) provides that for purposes of § 6211(a):

(A) any excess of the sum of the credits allowable under §§ 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.

Section 1.6664-2 does not specifically address how to factor the § 32 credit into the formula prescribed for calculating an underpayment. However, some guidance may be derived from the language of § 1.6664-2(b) and (c). Both of these subsections state that certain line items in the underpayment formula are to be computed "without regard" to the §§ 31 and 33 credits. This language suggests that such line items are to be computed "with regard" to other credits such as the § 32 credit.

Further, in the absence of specific guidance on this issue, a reasonable approach is to treat the § 32 credit as it is treated in a comparable context. The language used in § 6211(a)

includes the terms "the amount by which the tax imposed by subtitle A [income tax]" and "the amount shown as the tax by the taxpayer upon his return." These two terms are nearly identical to the § 1.6664-2(b) term "the amount by which any tax imposed by this title", the § 1.6664-2(c) term "amount shown as the tax by the taxpayer on his return", and the § 1.6664-2(d) term "tax shown on the return." The degree of similarity between the terms used in § 6211(a) and § 6664(a) provides a reasonable basis for treating the § 32 credit for purposes of § 6664 as the credit is treated in § 6211(b)(4). Therefore, when the § 32 credit exceeds the income tax imposed (determined without regard to the § 32 credit) or when the § 32 credit shown by the taxpayer on his return exceeds the amount shown as the tax by the taxpayer on his return (determined without regard to such credits) a negative amount of tax results. By analogy, the terms "amount of income tax imposed", "amount shown as the tax by the taxpayer on his return", and "the tax shown on the return" in § 1.6664-2 could be negative numbers that represent negative amounts of tax. The net effect of these principles is to compute an underpayment only when a negligently or fraudulently claimed EIC is refunded.

Within your request for Significant Advice, you provided two examples that demonstrate how the status of a refund may affect the calculation of an underpayment. As discussed above, the formula for computing an underpayment is:

$$\text{Underpayment} = W - (X + Y - Z)$$

- W = the amount of income tax imposed
- X = the amount shown as the tax by the taxpayer on his return
- Y = amounts not so shown previously assessed (or collected without assessment)
- Z = the amount of rebates made

In the following examples, the correct tax is zero (including self-employment tax), the correct EIC is zero, the taxpayer shows no tax on the return (including self-employment tax), and the taxpayer fraudulently claims a \$500 refund solely attributable to the EIC. In the first example, the refund was not made to the taxpayer. In the second example, the refund was made to the taxpayer.

Example 1: Underpayment When Refund Not Made

$$\text{Underpayment} = W - (X + Y - Z)$$

- W = 0
- X = (\$500)
- Y = \$500

$$Z = 0$$

$$\text{Underpayment} = 0 - ((\$500) + \$500 - 0)$$
$$\text{Underpayment} = 0$$

Example 2: Underpayment When Refund Made

$$\text{Underpayment} = W - (X + Y - Z)$$

$$W = 0$$
$$X = (\$500)$$
$$Y = 0$$
$$Z = 0$$

$$\text{Underpayment} = 0 - ((\$500) + 0 - 0)$$
$$\text{Underpayment} = \$500$$

In Example 1 where the Service has not issued a refund, there is no underpayment of tax. Therefore, the Service may not impose a civil fraud penalty. (We note that this memorandum does not address the application of criminal penalties to the facts of Example 1. See, e.g., §§ 7206 and 7207.) In Example 2 where the Service has issued a refund, there is an underpayment and the Service may impose the civil fraud penalty if the underpayment is due to fraud.

If you have any questions concerning Issue 1, please contact Peter Cohn at (202) 622-4930. If you have any questions concerning Issues 2 and 3, please contact Celia Gabrysh at (202) 622-4940.

JODY J. BREWSTER

By /s/
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