



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

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE SERVICE CENTER ADVICE

MEMORANDUM FOR Director, Reporting Compliance (Wage and Investment)
W:CP:EX

FROM: Assistant Chief Counsel (Administrative Provisions & Judicial
Practice) CC:PA:APJP

SUBJECT: Disallowance of Earned Income Tax Credit

This memorandum is in response to your request for Significant Service Center Advice dated July 30, 2001, in connection with questions posed by Remote Exam Headquarters. At issue are the procedures that the Internal Revenue Service (IRS) should follow when disallowing the earned income tax credit (EITC). This document is not to be used or cited as precedent.

ISSUES

1. What acts trigger the start of the 2-year period of limitations, under section 6532(a)(1) of the Code, for commencing a lawsuit to obtain a refund of an overpayment?
2. Certain versions of Form 4549, Income Tax Examination Changes, do not have any language by which the taxpayer waives the right to a claim disallowance letter; other versions place that language in the "Other Comments" (line 19) area, which is not near the signature line. Under what circumstances, if any, will the Form 4549 constitute a waiver under section 6532(a)(3) of the taxpayer's right to a notice of claim disallowance?
3. Must the IRS send a notice of deficiency when the EITC is disallowed in whole or in part? If the IRS sends a notice of deficiency and the taxpayer fails to file a timely Tax Court petition, must the IRS then send a notice of claim disallowance in cases in which the taxpayer has not waived the right to a notice of claim disallowance? Will the previously issued notice of deficiency be considered a notice of claim disallowance?
4. What are the proper procedures for handling EITC claims in the following scenarios?

WTA-N-140217-01

- A. Taxpayer claims EITC of \$2000 and shows a tax liability of \$0 on the return. Refund of \$2000 is held prior to the audit. EITC of \$2000 is recaptured resulting in no refund and no balance due.
- B. Taxpayer claims EITC of \$2000 and shows a tax liability of \$500 on the return. Refund of \$1500 is held prior to audit. The EITC of \$2000 is recaptured during the audit, resulting in a balance due of \$500.
- C. Taxpayer claims EITC of \$2000 and shows a tax liability of \$500 on the return. Refund of \$1500 is held prior to the audit. The EITC of \$2000 is recaptured during the audit, and there is an increase to tax of \$1000, resulting in a balance due of \$ 1500.
- D. Taxpayer claims EITC of \$2000 and shows a tax liability of \$0 on the return. Refund of \$2000 is held prior to audit. EITC of \$1000 is recaptured resulting in a partial refund of \$1000 to taxpayer.
- E. Taxpayer claims EITC of \$2000 and shows a tax liability of \$500 and withholding of \$1000 on the return. Refund of \$2500 is held prior to audit. EITC of \$2000 is recaptured resulting in a refund of \$500 to taxpayer.
- F. Taxpayer claims EITC of \$2000 and shows a tax liability of \$500 and withholding of \$1000 on the return. Refund of \$2500 is held prior to audit. EITC of \$2000 is recaptured and there is a tax increase of \$1000, resulting in a balance due of \$500.

CONCLUSION

1. The start of the 2-year period of limitations in section 6532(a)(1) is not triggered unless the IRS sends a notice of claim disallowance, by registered or certified mail, or the taxpayer waives the right to a notice of claim disallowance under section 6532(a)(3).
2. Treas. Reg. § 301.6532-1(c) provides four requirements for a waiver of notice of claim disallowance. The Form 4549 provided for our review does not meet the requirements of the regulations.
3. Unless math error procedures apply, the IRS should send a notice of deficiency when the EITC is disallowed. The IRS is not required to send a notice of claim disallowance. A statutory notice of deficiency is not a notice of claim disallowance.
4. In each of the situations the IRS should send a statutory notice of deficiency. It is not necessary to send a notice of claim disallowance.

FACTS

WTA-N-140217-01

Remote Examination administers several EITC programs. On occasion, the taxpayer's refund is held prior to the examination. Sometimes the examination results in a decrease in the EITC, but the taxpayer is still entitled to a refund. Occasionally, the decrease in the EITC and other changes (e.g., a change in filing status or loss of exemptions) eliminate the right to a refund and result in a balance due.

Upon completion of the examination, the IRS sends a report (Form 4549) to the taxpayer outlining the proposed changes. Coupled with the report is a letter asking for additional proof of entitlement to the EITC (school records, proof of address, etc.). Upon receipt, the taxpayer may sign the report thereby agreeing to the adjustments. If the taxpayer does not respond to the Form 4549 within 60 days, the IRS issues a notice of deficiency.

LAW AND ANALYSIS

Issue One

Section 6532(a)(1) provides, in part, that no suit or proceeding under section 7422(a) for the recovery of tax shall be begun before the expiration of 6 months after a claim for refund is filed (unless the IRS denies the claim within that time) or after the expiration of 2 years from the date of mailing by certified or registered mail of a notice of claim disallowance. Claims for refund may be filed on original or amended income tax returns. See Treas. Reg. § 301.6402-3(a)(5).

Section 6532(a)(3) provides that a taxpayer may file a written waiver of the requirement that the IRS send a notice of claim disallowance by certified or registered mail. The filing of such a waiver starts the running of the 2-year limitations period in section 6532(a)(1). To be effective, the waiver must include the type of tax and taxable period covered by the taxpayer's claim for refund, the amount of the claim, the amount of the claim disallowed, and a statement that the taxpayer agrees the filing of the waiver will commence the running of the 2-year period provided for in section 6532(a)(1). See Treas. Reg. §§ 301.6532-1(c)(1)-(4).

Thus, in order to trigger the 2-year period of limitations in section 6532(a)(1), the IRS must send the taxpayer a notice of claim disallowance by registered or certified mail or the taxpayer must waive notice of claim disallowance under section 6532(a)(3).

Issue Two

As stated above, a waiver must include the type of tax and taxable period covered by the taxpayer's claim for refund, the amount of the claim, the amount of the claim disallowed, and a statement that the taxpayer agrees the filing of the waiver will

WTA-N-140217-01

commence the running of the 2-year period provided for in section 6532(a)(1). The Form 4549 provided for our review does not meet these requirements. Also, the title of this form does not put the taxpayer on notice that he or she is waiving the right to a notice of claim disallowance. The Form 4549 is not an adequate waiver regardless of where the waiver language is placed.

As explained below, EITC cases should be handled under the deficiency procedures or under the math error procedures in certain cases. Thus, there is no need to issue a notice of claim disallowance or to obtain a waiver of claim disallowance from the taxpayer (Form 2297 is the prescribed waiver form).

Issue Three

Under section 6212, if the IRS determines a deficiency, the IRS is authorized to send a notice of deficiency to the taxpayer. Unless deficiency procedures are followed, the IRS cannot assess the tax increase attributable to the disallowed EITC. Also, without issuance of a notice of deficiency, the taxpayer cannot contest the IRS's disallowance of the EITC in the Tax Court. Thus, issuance of the notice of deficiency is essential when the EITC is disallowed in whole or in part.

A deficiency can exist only with respect to income, estate and certain gift and certain excise taxes and is defined as the amount by which the tax imposed exceeds the excess of (1) the sum of the amount of tax shown on the taxpayer's return, plus the amount previously assessed (or collected without assessment) as a deficiency, over (2) the amount of any rebates. See I.R.C. § 6211(a). The EITC is specifically included in the deficiency calculation as a negative amount of tax. See I.R.C. § 6211(b)(4). Thus, the IRS cannot reduce the EITC claimed without following the deficiency procedures. If the taxpayer files a timely Tax Court petition, the taxpayer will be able to contest the disallowance of the EITC in the Tax Court. See H.R. Rep. No. 100-795, at 366 (1988); S. Rep. No. 100-445, at 387 (1988); Wilson v. Commissioner T.C. Memo 2001-139; and Blore v. Commissioner T.C. Memo. 2000-326.

There is an exception to the rule that the IRS must follow deficiency procedures when disallowing all or part of the EITC. The exception applies when there is a mathematical or clerical error on the return. See I.R.C. § 6213(b)(1) and (2). Section 6213(g)(2) defines mathematical or clerical error. One such error of particular relevance occurs when the taxpayer omits a correct taxpayer identification number (TIN) on the return as required by section 32. See I.R.C. § 6213(g)(2)(F). The IRS should follow deficiency procedures unless all the errors on the return are mathematical or clerical errors as defined in section 6213(g)(2).

The issuance of a notice of claim disallowance starts the running of the 2-year period in which the taxpayer may file a refund suit in the United States District

WTA-N-140217-01

Court or the United States Court of Federal Claims. There is no requirement that a notice of claim disallowance be issued. The 2-year limitations period in section 6532(a) will not start running, however, if the IRS does not issue a notice of claim disallowance and the taxpayer does not waive the right to a notice of claim disallowance. This means that the period of limitations remains open indefinitely and the taxpayer could file a lawsuit many years after the taxpayer filed the claim with the IRS. See Detroit Trust Company v. United States 131 Ct. Cl. 223, 130 F. Supp. 815 (1955) and Rev. Rul. 56-381, 1956-2 C.B. 953.

We do not think it is necessary to issue a notice of claim disallowance even though the period of limitations for filing a refund suit will remain open indefinitely. As explained above, taxpayers who believe the IRS improperly denied the EITC may file a Tax Court petition upon issuance of the notice of deficiency. The Tax Court has jurisdiction to redetermine the EITC and order the IRS to issue a refund if the IRS improperly denied the EITC. See § 6512(b)(1) and (2). Thus, the Tax Court provides a convenient judicial forum for litigating disputes over the EITC, and this is especially the case because informal procedures may be available to taxpayers in small cases where the amount at issue does not exceed \$50,000. See § 7463. Thus, we do not think taxpayers are likely to file lawsuits in the United States District Court or the United States Court of Federal Claims to litigate a disallowed EITC long after the claim was filed with the IRS.

A notice of deficiency cannot be considered a notice of claim disallowance. Notices of deficiency are not issued for the purpose of disallowing refund claims. Rather, they are issued when the tax shown on the return is less than the actual tax liability, whether or not the taxpayer claims a refund on the return. Notices of deficiency and notices of claim disallowance contain very different information. In particular, a notice of deficiency explains the taxpayer's right to file a petition in the Tax Court. A notice of claim disallowance, on the other hand, explains the taxpayer's right to file a lawsuit in the United States District Court or the United States Court of Federal Claims to recover an overpayment of tax.

Issue Four

In each scenario stated, a statutory notice of deficiency must be issued, whether or not the taxpayer is entitled to a refund, unless all the errors on the return are mathematical or clerical errors under section 6213(g)(2). As stated earlier, the IRS is not required to issue a notice of claim disallowance. Failure to do so, however, prevents the commencement of the running of the 2-year period of limitations for filing a tax refund suit pursuant to section 6532 (unless the taxpayer waives his or her right to a notice of claim disallowance).

Example A

WTA-N-140217-01

On his return, taxpayer claims an EITC of \$2000 and shows a tax liability of \$0. The refund of \$2000 is held prior to the audit. EITC of \$2000 is recaptured resulting in no balance due and no refund.

In this case, there is a deficiency because the tax shown on the return (-\$2000) is less than the actual tax liability (\$0). The EITC of \$2000 is a negative amount of tax on the return.

Example B

Taxpayer claims EITC of \$2000 and shows a tax liability of \$500. The refund of \$1500 is held prior to audit. The EITC of \$2000 is recaptured during the audit, resulting in a balance due of \$500.

In this case, there is a deficiency because the tax shown on the return (-\$1500) is less than the actual tax liability (\$500). The EITC of \$2000 is a negative amount of tax.

Example C

Taxpayer claims EITC of \$2000 and shows a tax liability of \$500. The refund of \$1500 is held prior to the audit. The EITC of \$2000 is recaptured during the audit, and there is an increase to tax of \$1000, resulting in a balance due of \$1500.

In this case, there is a deficiency because the tax shown on the return (-\$1500) is less than the actual tax liability (\$1500). The EITC of \$2000 is a negative amount of tax.

Example D

Taxpayer claims EITC of \$2000 and shows a tax liability of \$0. The refund of \$2000 is held prior to audit. EITC of \$1000 is recaptured resulting in a partial refund of \$1000 to taxpayer.

In this case, there is a deficiency because the tax shown on the return (-\$2000) is less than the actual tax liability (-\$1000). The EITC of \$2000 is a negative amount of tax.

Example E

Taxpayer claims EITC of \$2000 and shows a tax liability of \$500 and withholding of \$1000. The refund of \$2500 is held prior to audit. EITC of \$2000 is recaptured resulting in a refund of \$500.

WTA-N-140217-01

In this case, there is a deficiency because the tax shown on the return (-\$1500) is less than the actual tax liability (\$500). The EITC of \$2000 is a negative amount of tax.

Example F

Taxpayer claims EITC of \$2000 and shows a tax liability of \$500 and withholding of \$1000. Refund of \$2500 is held prior to audit. EITC of \$2000 is recaptured and there is a tax increase of \$1000 resulting in a balance due of \$500.

In this case, there is a deficiency because the tax shown on the return (-\$1500) is less than the actual tax liability (\$1500). The EITC of \$2000 is a negative amount of tax.

If you have any questions regarding this response, please contact Branch 2 of the Administrative Provisions & Judicial Practice Division at (202) 622-4940.

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