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

OFFICE OF
CHIEF COUNSEL

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MEMORANDUM FOR DISTRICT COUNSEL, BROOKLYN
CC:NER:BRK

FROM: Assistant Chief Counsel
CC:TEGE:EOEG

SUBJECT: Significant Service Center Advice

This responds to your request for Significant Advice received February 8, 2000 in connection with a question posed by the Management Analyst at the Brookhaven Service Center.

Issues

The four issues identified below arise from the following situation. As part of his timely-filed federal income tax return, a taxpayer reports (on Schedule C (Profit and Loss from Business (Sole Proprietorship))) net income from a business, tax under the Self-Employment Contributions Act ("SECA" or "self-employment tax") based on that business income, and an earned income tax credit based on that business income. A refund is issued to the taxpayer. As a result of an examination, the Service determines that the taxpayer has not substantiated the income and expenses reported on Schedule C, so all items on that Schedule are disallowed. Since the taxpayer no longer has net business income, the Service abates the self-employment tax and asserts a deficiency in income tax (because the taxpayer is no longer entitled to an earned income credit on the basis of the Schedule C net income). The taxpayer pays the deficiency and files a timely claim for refund after the statute of limitations for assessment of tax has expired.

1. Whether, notwithstanding the expiration of the statute of limitations for assessments, the self-employment tax may be re-assessed on the basis that such tax was originally reported by the taxpayer on a timely return.

2. If not, whether self-employment tax may be considered an appropriate offset (under Lewis v. Reynolds, 284 U.S. 281 (1932)) to an income tax refund claim filed after the expiration of the statute of limitations for assessment of self-employment tax.

3. If an offset is appropriate, whether a procedure needs to be devised by which the net amount of the refund may be processed.

4. If an offset is appropriate, whether a procedure needs to be devised for ensuring that the taxpayer receives credit with the Social Security Administration for the self-employment income.

Conclusion

Based on the facts provided, we conclude:

1. The fact that self-employment tax was previously reported on a taxpayer's return before it was abated does not provide a legal exception to the bar against assessing self-employment tax after the period of limitations for assessment of that tax has expired.

2. The self-employment tax may be considered in determining whether an offset is appropriate under Lewis v. Reynolds, supra, when a taxpayer files a claim for refund after the statute of limitations for assessment has expired.

3. A procedure should be designed by which the refund from the earned income credit can be offset by the self-employment tax that can not be assessed due to the expiration of the statute of limitations for assessment. This issue has been forwarded to the Office of Employment Tax, Administration and Compliance (OETAC) to provide assistance in creating such a procedure.

4. A procedure should be designed to notify taxpayers (1) that because the three-year, three-month, fifteen-day period for electronic adjustments has expired, their Social Security records will not reflect the amount of the income from self-employment that was reported on their timely-filed returns; and (2) that they should notify the Commissioner of Social Security that their records should be adjusted. This issue has been forwarded to OETAC to provide assistance in creating such a procedure.

Facts

In addition to the facts contained in your request, we have spoken to several people in the Brookhaven Customer Service Center and the Social Security Administration to understand the procedures that are used to process self-employment taxes and the earned income credit. Since your request involves a question that is not tied to a specific taxpayer, we have restated the facts in terms of Taxpayer, a hypothetical individual, so that we may clearly set forth each of the procedural steps taken in the service center. The facts as we understand them are as follows:

Taxpayer files a timely income tax return[1] that includes a Schedule C on which is reported income and expenses from a business. Since Taxpayer has reported net earnings from self employment, Taxpayer reports liability for self-employment tax on line 50 of the return. Taxpayer also claims an earned income credit on line 59a based on the net income from the business that is reported on Schedule C. Taxpayer requests a refund (because the earned income credit is greater than the self-employment tax reported on the return).

When the return is received, the service center processes the information on the return in the Indegrated Data Retrieval System (IDRS). Some information is processed with "transaction codes" whereas other information is processed with "reference codes." Generally, the information with transaction codes is used to determine Taxpayer's total tax liability to be assessed, as well as Taxpayer's account balance. The underlying details of the return that netted together result in the items processed with transaction codes are entered with "reference codes."

As relevant here, the amount of net earnings from self-employment is entered into the computer system with a reference code. The information associated with the reference codes for net earnings from self-employment is sent to the Commissioner of Social Security via a magnetic tape. That information is used by the Social Security Administration (SSA) to credit Taxpayer with self-employment income for that taxable year so that the Social Security records used to calculate Taxpayer's Social Security benefits will reflect those earnings.

Thereafter, the examination branch of the service center audits Taxpayer's return and requests Taxpayer to provide information to substantiate the income and expenses reported on Schedule C from Taxpayer's business. The examination branch determines that Taxpayer's response fails to substantiate adequately the items reported on Schedule C. As a result, the examination branch proposes to disallow (1) all items on Schedule C, (2) the self-employment tax based on the business income, and (3) the earned income credit based on the business income. Although the adjustment reduces gross income and self-employment tax, the disallowance of the earned income credit creates a deficiency in income tax. A notice of deficiency is issued and Taxpayer does not file a Tax Court petition.

In assessing the deficiency, the additional income tax amount is input into the computer system with a transaction code and the earned income credit amount is input with a transaction code to recapture the earned income credit. At the same time, an entry is made with a reference code to reduce the net earnings from self-employment to zero. The information that Taxpayer's self-employment income is

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[1]References to Taxpayer's return will be to a 1999 Form 1040 (U.S. Income Tax Return).

zero for the taxable year will be transmitted to SSA via magnetic tape for SSA to adjust Taxpayer's benefit account to reflect zero self-employment income.

Finally, Taxpayer files a claim for refund and provides substantiation for the items reported on Schedule C of Taxpayer's return. The Service agrees that Taxpayer (1) had Schedule C income and expenses, (2) is entitled to the earned income credit and (3) is liable for self-employment tax on the net income from business. But by the time this determination is made, the statute of limitations for assessment has expired.

If the statute of limitations had not expired, the service center would input into the computer system the additional total tax (income tax from an increase in income and self-employment tax attributable to the net business income) with the transaction code for total tax, an earned income tax credit with its transaction code, and the amount of the net income from self-employment with its reference code so that Social Security Administration would receive notice that Taxpayer should be credited with self-employment income for the taxable year. These transactions would result in an overpayment of tax and Taxpayer would be sent a refund.

But because the statute of limitations for assessments has expired, the law prohibits the assessment of the additional tax. No current procedures exist to process the self-employment income so that Taxpayer's social security account will be corrected or to process a refund that reflects the proper amount of earned income credit and offsetting SECA tax.

Discussion

Issue 1 - Assessment after expiration of the statute of limitations for assessment

Section 6501(a) of the Internal Revenue Code of 1986 ("Code") provides that with certain exceptions, any tax imposed by the Code shall be assessed within three years after the return was filed. If a taxpayer's return is filed by its due date, and the Service does not assess any additional tax with respect to that tax period within three years, the tax generally cannot be collected through a court proceeding (I.R.C. § 6501(a)) or by an administrative levy (I.R.C. § 6502(a)).

There are statutory exceptions to the three-year rule. If a taxpayer files a false or fraudulent return, willfully attempts to defeat or evade certain taxes, or fails to file a return, the Service can assess the tax at any time. I.R.C. § 6501(c)(1), (2), (3). Other special rules apply when certain tax credits are affected, a taxpayer's private foundation status is terminated, an amended return is filed shortly before expiration of the limitations period for assessments, certain information returns are not properly filed, and certain property transfers increase gift tax. I.R.C. § 6501(c)(5), (6), (7), (8), (9). If, before the period of limitations for assessments has expired, the taxpayer and the Service agree in writing to extend the period for assessments, tax may be assessed within that extended period. I.R.C. § 6501(c)(4). If the return omits certain substantial items, the period of limitations for assessment may be six rather than three years. I.R.C. § 6051(e).

None of the statutory exceptions apply to the situation at issue. Thus, section 6501(a) bars the assessment of tax after the expiration of the three-year period following the timely filing of Taxpayer's return.

You ask whether, notwithstanding the bar against assessment, the tax can be re-assessed because the tax was initially assessed on the basis of the information contained on Taxpayer's return. There is no authority for such action. Section 6404(a) generally authorizes the Service to abate tax liability that is excessive in amount, that is assessed after the expiration of the period of limitations, or that is erroneously or illegally assessed.

Generally, when an assessment is abated, it is thereby canceled and cannot be resurrected if the Service later decides that its decision was incorrect. Crompton-Richmond, Co. v. United States, 311 F. Supp. 1184, 1186 (S.D.N.Y. 1970). Instead, the Service must make a new assessment. A few cases, however, recognize limited circumstances in which an abated assessment may be reinstated, even when the statute of limitations precludes a new assessment. In re Bugge, 99 F.3d 740 (5th Cir. 1996); Crompton-Richmond Co. v. United States, supra.

In Crompton-Richmond, the district court set forth the following rule (311 F.Supp. at 1188):

> A distinction must be drawn between a substantive reconsideration of the taxpayer's liability by the IRS and a clerical error committed by the IRS that has the same effect. Whenever an abatement is issued because of a mistake of fact or bookkeeping error, the assessment can be reinstated, at least so long as this does not prejudice the taxpayer.

The Internal Revenue Manual references this case as authority to reverse an abatement. IRM 57(16)5.2; see also IRM 3.17.46.2.8.

The particular error in Crompton-Richmond involved a section 6672 penalty that was assessed against more than one responsible person. When one of the responsible persons paid the penalty and the limitations period to file a refund suit elapsed, the District Director believed the 100% penalty had been satisfied and was not subject to refund. He therefore requested that the Service Center abate the assessment against the other responsible persons.

The District Director was unaware, however, that the person who paid the 100% penalty had filed a timely refund suit that was still pending. Thus, the

Director's request was based on a mistake of fact. Moreover, in granting the Director's request, the Service Center was operating under the same mistake of fact. Accordingly, applying the above-quoted rule, the court found the assessment could be reinstated.

In further explaining why the abated assessment could be reinstated, the court contrasted abatements based on clerical errors or mistakes of fact with abatements made only after review of assessments upon the merits and after re-evaluation of the taxpayer's liability. "In this latter situation the Commissioner is understandably precluded from canceling an abatement and reinstating an assessment merely because, upon further consideration, he has decided to change his position." Crompton-Richmond, 311 F. Supp. at 1187.

Unlike the abatement at issue in Crompton-Richmond, the abatement here was not the result of a clerical mistake or mistake of fact. Rather, the decision to abate Taxpayer's self-employment tax was made after the examination branch reviewed his return and re-evaluated Taxpayer's liability. Thus, it was not the kind of abatement that could be reversed or reinstated after the expiration of the statute of limitations.

It should be noted that the Fifth Circuit has adopted a different analysis than the court in Crompton-Richmond. In In re Bugge, 99 F.3d 740 (5th Cir. 1996), the court considered whether the Service could rely on the assessment that was erroneously abated. The court rejected the analysis in Crompton-Richmond and held that no effective tax abatement under the statutory authority of I.R.C. §§ 6404(a)(1) ever occurred. 99 F.3d at 745. The court reasoned that the elimination of the taxpayer's entire liability was an unintended abatement lacking any authorization.

Since the ruling in Bugge, the Service has had opportunity to consider the two standards articulated in Crompton-Richmond and Bugge. In significant service center advice dated October 22, 1999, the Service declined to adopt the standard set forth in Bugge citing vagueness regarding the types of abatements that would be considered unauthorized. The Service reaffirmed its commitment to the Crompton-Richmod standard found in the Internal Revenue Manual. Nevertheless, even under the Bugge standard, a reversal of the abatement is not supported in the present case.

Since the facts in this case do not fall within the situation where an inadvertent abatement may be reinstated after the expiration of the statute of limitations for assessment, Taxpayer's self-employment tax cannot be assessed.

Issue 2 - Offset of SECA tax liability against income tax refund

Code section 6402(a) authorizes the Service to refund overpayments of tax liability. A taxpayer is not entitled to a refund unless the taxpayer has in fact overpaid the tax. In Lewis v. Reynolds, 284 U.S. 281 (1932), the Supreme Court set forth a broad concept of overpayment, treating it as a payment in excess of what *properly* should have been assessed and collected as tax. In Lewis v. Reynolds, the taxpayer, an executor of an estate, filed a return in which he claimed deductions for attorney's fees and state inheritance taxes. After audit, the deduction for the state inheritance taxes was disallowed. Thereafter, the taxpayer filed a timely claim for refund. The Service rejected the claim on the ground that a further review determined that the deduction for attorney's fees was improperly allowed. A recomputation of the tax liability resulted in additional tax that was greater than the tax paid. This additional tax was barred from assessment by the statute of limitations. The Supreme Court held that the taxpayer was not entitled to a refund unless he had overpaid his tax, and stated (284 U.S. at 283):

> An overpayment must appear before refund is authorized. Although the statute of limitations may have barred the assessment and collection of any additional sum, it does not obliterate the right of the United States to retain payments already received when they do not exceed the amount which might have been properly assessed and demanded.

Thus, where a taxpayer has filed a timely claim for refund, but the Service determines that additional taxes should have been assessed, the Service may offset the refund amount by the amount of tax liability that is barred from assessment because of the expiration of the statute of limitations.

You ask whether the Lewis v. Reynolds doctrine is available to offset a refund attributable to a credit on income tax by self-employment taxes. Section 1401 of the Code imposes a tax on the self-employment income of every individual. The SECA tax is an income tax under chapter 2 of subtitle A of the Code. The regular income tax imposed on individuals is an income tax under chapter 1 of subtitle A.

There is an extremely close connection between the SECA tax and the regular income tax. See S. Rep. No. 1669, 81st Cong., 2d Sess. 153 (1950), 1950-2 C.B. 302, 353 (Senate Finance committee noted SECA tax should be "handled in all particulars as an integral part of the income tax"). Section 1.1401-1(a) of the Income Tax Regulations provides that the self-employment tax will be levied, assessed, and collected as part of the income tax imposed by subtitle A of the Code and, except as otherwise expressly provided, will be included with the tax imposed by Section 1 or 3 of the Code in computing any deficiency or overpayment and in computing the interest and additions to any deficiency, overpayment, or tax. Form 1040, must be used for both the regular income tax and the SECA tax. Treas. Reg. § 1.6017-1(a)(2). See also Rev. Rul. 82-185, 1982-2

C.B. 395 (filing of Form 1040 without any mention of SECA tax nevertheless starts the running of the statute of limitations for assessment of SECA tax).

Under the Lewis v. Reynolds doctrine, Taxpayer's entire income tax liability reportable on Form 1040 for a particular year became open for redetermination when his refund claim was filed. Since the SECA tax is closely related to the income tax, the Service has a right to reduce the refund otherwise available from the earned income credit on income tax by Taxpayer's SECA tax liability.

Issue #3 - Processing the refund when no SECA tax can be assessed

As discussed in Issues One and Two above, Taxpayer's SECA tax cannot be assessed after the statute of limitations for assessments has expired, but may be offset against the refund due Taxpayer as a result of the earned income credit. You have indicated that the IDRS system will permit the entry of an earned income credit, but not the SECA tax offset (because the assessment is barred by the statute of limitations). Thus, a new procedure must be developed for processing the refund in the proper amount (to reflect the SECA tax offset).

We have asked OETAC to assist you and the Brookhaven Service Center in developing such a procedure. We suggest that in addition to whatever measures must be taken at the Service Center to generate a refund in the proper amount, and update Taxpayer's account balance, Taxpayer should be notified that the Service has properly reduced the refund by the self-employment tax offset. In addition, as discussed below, we suggest that the notice to Taxpayer also inform him of the need to contact the Commissioner of Social Security in order to have his Social Security records corrected to reflect whatever income from self-employment was reported on his timely-filed return.

Issue #4 - Notifying Social Security Administration of self-employment income

The Commissioner of Social Security must establish and maintain records of the amounts of self-employment income derived by each individual and the periods in which such income was derived. 42 U.S.C. § 205(c)(2)(A). For the period of three years, three months, and fifteen days following the end of an individual's taxable year, the Commissioner may make all corrections to an individual's self-employment income records that come to the attention of the Commissioner. 42 U.S.C. § 405(c)(4); 20 C.F.R. § 404.821. After that time period, however, the Commissioner is authorized to correct an individual's self-employment income records only in limited circumstances. 42 U.S.C. § 405(c)(5)(A)-(J). As relevant here, after the three-year, three-month, fifteen-day period has expired, the Commissioner of Social Security may nevertheless correct an individual's income from self-employment records to conform to the individual's tax returns filed with the Internal Revenue Service, but only if the returns were filed with the Service within three years, three months, and fifteen days following the end of the individual's taxable year. 42 U.S.C. § 405(c)(5)(F)(i); 20 C.F.R. § 404.822.

In the circumstances of the present case, Taxpayer's income tax return that properly reported self-employment income was filed with the Service in a timely fashion, that is, four months and fifteen days following the end of his taxable year. Thus, under the Social Security statue and regulations, the Commissioner of Social Security would be authorized to make corrections to Taxpayer's self-employment income records even beyond the three-year, three-month, fifteen-day period of limitations on correcting records.

Under the procedures established by the Social Security Administration, however, information about a taxpayer's self-employment income that is transmitted to Social Security Administration via a magnetic tape automatically updates the taxpayer's Social Security records only if the information is received within the three-year, three-month, fifteen-day period described in 42 U.S.C. § 405(c)(4). After that period has expired, the Social Security records cannot be electronically updated by information that is received from the Service. Rather, the Social Security Administration will correct a taxpayer's records if the taxpayer brings the information to the attention of the Commissioner of Social Security.

Accordingly, we recommend that in conjunction with the procedure described in Issue Three, above, a notice be sent to Taxpayer with the refund, informing him that in order to qualify for Social Security benefits based on the income from self-employment that was reported on his timely-filed return, Taxpayer should contact the Commissioner of Social Security to have his records corrected.

We have asked the Office of Employment Tax, Administration and Compliance to work with you and the Brookhaven Service Center to create the procedure by which the proper refund can be issued and the notice sent to Taxpayer concerning his Social Security records.

MARY OPPENHEIMER
Assistant Chief Counsel
(Exempt Organization/Employment Tax/
Government Entities)
By: JERRY E. HOLMES
Chief, Employment Tax 2