

**ACKNOWLEDGED SIGNIFICANT ADVICE, MAY BE DISSEMINATED**

Internal Revenue Service  
memorandum

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date: May 21, 1997

to: District Counsel, South Texas District

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

subject: Significant Service Center Advice Concerning Whether  
to Issue a Notice of Deficiency for Disallowance of  
Earned Income Credit

This responds to your request for Significant Service Center Advice dated February 24, 1997, in connection with issues raised by the Examination Branch of the Philadelphia Service Center concerning the earned income credit. Your office posed six hypothetical examples. These examples raise the issue of whether the Internal Revenue Service (Service) should issue a statutory notice of deficiency for the disallowance of the earned income credit and the effect, if any, caused by, freezing the refund sought. The analysis contained herein does not take into account the changes in law with respect to earned income credit due to the enactment of the Personal Responsibility and Work Opportunity Act of 1996. Those changes effect returns, the due date of which without regard to extensions, is more than 30 days after August 22, 1996, the date of enactment of the Act.

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 Paragraphs III.D.4. and IV.A.5. of Office of Chief Counsel Notice N(35)000-143, Service Center Advice Procedure. 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 question 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.

Issue

Whether the Service must issue a statutory notice of deficiency prior to assessment under the factual scenarios described below?

### Conclusion

The Service must issue a statutory notice of deficiency prior to assessment under all of the factual scenarios described below.

### Discussion

The questions set out below raise the issues of whether the Service must issue a notice of deficiency and whether the Service must issue a notice of claim disallowance. The first issue involves an analysis of deficiency procedures while the latter issue requires analysis of the refund litigation process.

#### 1. Deficiency procedures.

Section 6212(a) provides that if the Secretary determines there is a deficiency with respect to various types of tax, including income tax imposed by subtitle A, the Secretary is authorized to send notice of such deficiency to the taxpayer. Section 6213(a) provides that, in general, a taxpayer may file a petition for redetermination with the United States Tax Court within 90 days of the mailing of the notice of deficiency. The Service is prohibited from assessing the deficiency during this 90 day period. If the taxpayer fails to file a petition with the Tax Court during this period, then the Service may assess the deficiency.

Section 6211(a) sets out the definition of deficiency by using the following formula: a deficiency equals the correct tax imposed minus the total of the tax on the taxpayer's return minus prior assessments plus rebates. Section 6211(b)(1) provides that the tax imposed by subtitle A shall be determined for the purposes of section 6211(a) without regard to the credit under section 31 (tax withheld on wages). Thus, the withholding amounts set out in the examples above will not affect the deficiency formula.

Section 32 provides for a credit against earned income to certain eligible individuals and is commonly referred to as the "earned income credit."

Section 6211(b)(4) provides:

- (4) 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.

This language was added to the Code by section 1015(r)(2) of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA). The legislative history explained that under the law in effect prior to the Act "deficiency procedures allowing taxpayers to litigate issues in the Tax Court relating to the earned income credit (sec. 32) . . . may not apply." H.R. Rep. No. 100-795, 100th Cong., 2d Sess. 366, and S. Rep. No. 100-445, 100th Cong., 2d Sess. 387. TAMRA added new section 6211(b)(4) which "provides that the Tax Court deficiency procedures apply to credits allowable under section 32 . . . notwithstanding that the credits reduce the net tax to less than zero." H.R. Rep. No. 100-795, 100th Cong., 2d Sess. 366, and S. Rep. No. 100-445, 100th Cong., 2d Sess. 387.

The language "negative amounts of tax" means that the credit amount must be considered even if it is a negative number. When part or all of a claimed credit described in section 6211(b)(4) is disallowed, the calculation will result in a deficiency. Therefore, the Tax Court would have jurisdiction where the calculation would result in a deficiency. The determination of the deficiency can be summarized by the following formula:

a) Tax shown less section 6211(b)(4) credit shown = tax on return;

b) Correct tax less correct section 6211(b)(4) credit = tax imposed;

c) Tax imposed less tax on return = deficiency.

## 2. Refund litigation.

28 U.S.C. § 1346(a) provides the district courts and the United States Court of Federal Claims with jurisdiction over refund claims. Section 7422 requires administrative exhaustion before a taxpayer may bring a refund action. United States v. Williams, 115 S.Ct. 1611 (1995). Section 7422(a) provides that [n]o suit or proceeding shall be maintained in any court for recovery of any internal revenue tax alleged to have been collected . . . until a claim for refund or credit has been duly filed . . . ." Section 7422(a) prevents the district courts and the United States Court of Federal Claims from hearing a refund suit prior to the taxpayer presenting the claim for refund to the Service. Zernial v. United States, 714 F.2d 431, 435 (5th Cir. 1983).

In general, taxpayers have three years from the time the return was filed or two years from the time the tax was paid, whichever is later, to file a claim for refund pursuant to section 6511(a). Thus, for purposes of section 6511(a), a claim for refund is timely unless it is filed more than 3 years from the time the return was filed regardless of when the return is filed. Rev. Rul. 76-511, 1976-2 C.B. 42B; Notice N(35)000-111. Pursuant to Treas. Reg. § 301.6402-3(a), an administrative claim for refund must be made on the appropriate tax return, amended return, or Form 843. Therefore a claim for refund made on an original return would be filed within three years of the time that the return is filed. Accordingly, the claims for refund in all of your examples were made on original returns and thus, are timely filed for purposes of section 6511(a). Full payment of tax has to be made before the taxpayer may sue for refund in the district court or in the United States Court of Federal Claims. Flora v. United States, 362 U.S. 145 (1960).

Section 6532(a)(1) provides the general rule that no refund suit under section 7422(a) shall be commenced before 6 months after the refund claim was filed unless the Service denies the claim within that time or after the expiration of 2 years from the date of mailing by certified or registered mail to the taxpayer of the notice of disallowance. There is no statutory provision in the Code mandating the Service to mail a notice of disallowance. Thus, the Service is not statutorily required to issue a notice of disallowance. Failure by the Service to do so, however, prevents the commencement of the running of the 2 year statute of limitations period for filing a tax refund suit.

3. Factual Scenarios.

You have posited the following six factual scenarios. We are assuming for the purposes of our response that all the returns were signed and filed by the taxpayer in question.

Example 1:

The taxpayer files a Form 1040, U.S. Individual Income Tax Return, setting out the following information:

Tax	\$500
Withholding	\$700
Refund	\$200

In processing the return, the Service determines that the taxpayer has claimed an unallowable deduction and that the tax should be \$700. The Service freezes the taxpayer's \$200 refund.

Questions:

1. Does the Service have to issue a notice of deficiency to increase the tax assessment from \$500 to \$700 and keep the frozen refund?
2. Can the Service assess the increase in tax without a notice of deficiency and keep the refund?
3. Does the Service need to issue a notice of claim disallowance if the frozen refund is not released to the taxpayer?

Answers:

We determine the deficiency by reference to the following formula:

a) Tax shown (\$500) less section 6211(b)(4) credit shown (\$0) = tax on return (\$500);

b) Correct tax (\$700) less correct section 6211(b)(4) credit (\$0) = tax imposed (\$700);

c) Tax imposed (\$700) less tax on return (\$500) = deficiency (\$200).

In this instance, there is a deficiency of \$200. Thus, the Service cannot assess an increase in tax without first issuing a statutory notice of deficiency. By freezing the refund, the taxpayer will be considered at full pay status for refund litigation purposes. The Service, however, is not statutorily required to issue a notice of disallowance.

Example 2:

The taxpayer files a Form 1040, U.S. Individual Income Tax Return, setting out the following information:

Tax	—0—
Earned Income Credit	\$1,000
Refund	\$1,000

In processing the return, the Service determines that the taxpayer is not entitled to the earned income credit. The Service freezes the taxpayer's \$1,000 refund.

Questions:

1. Does the Service have to issue a notice of deficiency to keep the frozen refund?
2. Can the Service keep the frozen refund and reverse the earned income credit allowed on the taxpayer's account?
3. Does the Service need to issue a notice of claim disallowance if the frozen refund is not released to the taxpayer?

Answers:

We determine the deficiency by reference to the following formula:

a) Tax shown (\$0) less section 6211(b)(4) credit shown (\$1000) = tax on return (-\$1000);

b) Correct tax (\$0) less correct section 6211(b)(4) credit (\$0) = tax imposed (\$0);

c) Tax imposed (\$0) less tax on return (-\$1000) = deficiency (\$1000).

In this instance, there is a deficiency of \$1000 (\$0 - (-\$1000) = +\$1000). Thus, the Service cannot reverse the earned income credit claimed without first issuing a statutory notice of deficiency. By freezing the refund, the taxpayer will be considered at full pay status for refund litigation purposes. The Service, however, is not statutorily required to issue a notice of disallowance.

Example 3:

The taxpayer files a Form 1040, U.S. Individual Income Tax Return, setting out the following information:

Tax	\$500
Earned Income Credit	\$1,000
Withholding	\$1,500
Refund	\$2,000

In processing the return, the Service determines that the tax should be \$600 and the earned income credit should be \$900. The Service freezes \$200 of the taxpayer's refund.

Questions:

1. Does the Service have to issue a notice of deficiency to increase the taxpayer's tax by \$100 and to decrease the earned income credit by \$100?
2. Can the Service, because of the frozen refund, assess additional tax and reduce the earned income credit without issuing the notice of deficiency?
3. Does the Service need to issue a notice of claim disallowance if the frozen refund is not released to the taxpayer but is used to pay any additional assessment?

Answers:

We determine the deficiency by reference to the following formula:

a) Tax shown (\$500) less section 6211(b)(4) credit shown (\$1000) = tax on return (-\$500);

b) Correct tax (\$600) less correct section 6211(b)(4) credit (\$900) = tax imposed (-\$300);

c) Tax imposed (-\$300) less tax on return (-\$500) = deficiency (\$200).

In this instance, there is a deficiency of \$200 ( $-\$300 - (-\$500) = +\$200$ ). Thus, the Service cannot assess the increase in tax of \$100 nor reverse \$100 of the earned income credit claimed without first issuing a statutory notice of deficiency. By freezing the refund, the taxpayer will be considered at full pay status for refund litigation purposes. The Service, however, is not statutorily required to issue a notice of disallowance.

Example 4:

Same facts as Example 1, except in this example the refund is made to the taxpayer.

Question:

1. Does the Service have to issue a notice of deficiency to assess the increase in the tax liability and collect the underpayment of tax?

Answer:

The answer is the same as in example 1, above. Again, there is a deficiency of \$200. The Service cannot assess an increase in tax without first issuing a statutory notice of deficiency.

Example 5:

Same facts as Example 2, except in this example the refund is made to the taxpayer.

Question:

1. Does the Service have to issue a notice of deficiency to decrease the earned income credit claimed on the return and collect the refund previously made?

Answer:

The answer is the same as in example 2, above. Again, there is a deficiency of \$1000. The Service cannot reverse the earned income credit claimed without first issuing a statutory notice of deficiency.

Example 6:

Same facts as Example 3, except in this example the refund is made to the taxpayer.

Question:

1. Does the Service have to issue a notice of deficiency to increase the tax liability and decrease the earned income credit shown on the return?

Answer:

The answer is the same as in example 3, above. Again, there is a deficiency of \$200. The Service cannot assess the increase in tax or reverse \$100 of the earned income credit claimed without first issuing a statutory notice of deficiency.

Summary

Using the deficiency formula set out above, examples 1 through 6 would all require the issuance of a statutory notice of deficiency. The Service cannot assess an increase in tax or decrease in earned income credit without first issuing a statutory notice of deficiency. The freezing of the taxpayer's refund has no impact on the determination of whether a notice of deficiency needs to be issued.

In examples 1 through 3, the taxpayer will be considered at full pay status for refund litigation. The Service is not statutorily required to issue a notice of disallowance in any

case. Failure by the Service to do so, however, prevents the commencement of the running of the 2 year statute of limitations period for filing a tax refund suit.

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