



OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
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INTERNAL REVENUE SERVICE NATIONAL OFFICE CHIEF COUNSEL ADVICE

MEMORANDUM FOR TIMOTHY B. HEAVNER
CC:SER:VWV:RCH

FROM: Assistant Chief Counsel (Employee Benefits and Exempt Organizations)

SUBJECT: Earned Income Credit and Schedule C Activities

This Chief Counsel Advice responds to your memorandum requesting advice regarding the interplay between eligibility for the earned income credit under Internal Revenue Code (I.R.C.) § 32 and net earnings from self-employment under I.R.C. §1402. Chief Counsel Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

ISSUES

- (1) How are a taxpayer's Earned Income Credit (EIC) and self-employment tax liability computed in cases where the taxpayer reports net earnings from self-employment on Schedule C without claiming the business expenses applicable to the Schedule C business?
- (2) How are a taxpayer's EIC and self-employment tax liability computed in cases where the taxpayer reports net earnings from self-employment on Schedule C but cannot show that the business exists?

CONCLUSIONS

- (1) In cases where the taxpayer reports net earnings from self-employment without claiming the applicable business expenses, the net earnings from self-employment must be adjusted by those business expenses. The taxpayer's EIC and self-employment tax liability are both computed on the adjusted net earnings from self-employment.

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- (2) In cases where the taxpayer reports net earnings from self-employment but cannot show that the business exists, the taxpayer cannot claim the EIC based on those net earnings from self-employment. In addition, the taxpayer is not liable for self-employment tax on those net earnings.

FACTS

You did not provide specific facts. Instead you indicated you have received questions on the how the EIC is determined in cases involving taxpayers who have claimed the EIC based on net earnings from self-employment reported on Schedule C. Taxpayers report an amount of net earnings from self-employment that maximizes the taxpayers' EIC. However, in certain cases, it appears that either the taxpayer did not claim the business expenses related to the self-employment business or that the business does not exist.

LAW AND ANALYSIS

Under I.R.C. § 32(a), the earned income credit is determined as an amount equal to the credit percentage of so much of the taxpayer's earned income for the taxable year as does not exceed the earned income amount. I.R.C. § 32(c)(2) defines "earned income" as "wages, salaries, tips, and other employee compensation, plus the amount of the taxpayer's net earnings from self-employment for the taxable year (within the meaning of section 1402(a))"

I.R.C. § 1402(a) defines "net earnings from self-employment" as "the gross income derived from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business" I.R.C. § 162 provides for the deduction of all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. In general, expenses are deductible in the taxable year which is the proper taxable year under the method of accounting used to determine taxable income.

There are, therefore, two necessary elements for determining "net earnings from self-employment": gross income derived from the trade or business and allowable deductions attributable to the trade or business that produced that gross income. Gross income from a trade or business does not itself constitute net earnings from self-employment; allowable deductions must be taken for expenses in order to arrive at net earnings from self-employment. A taxpayer normally reports both of these elements on a Schedule C.

Revenue Ruling 56-407, 2 C.B. 564, addressed the issue of whether taxpayers may disregard allowable deductions in computing net earnings from self-

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employment for self-employment tax purposes. Rev. Rul. 56-407 held that under § 1402(a), every taxpayer (with the exception of certain farm operators) must claim all allowable deductions in computing net earnings from self-employment for self-employment tax purposes. Because the net earnings from self-employment that are included in earned income for EIC purposes are defined by cross-reference to the definition of net-earnings from self-employment under I.R.C. §1402(a), this ruling applies equally to the EIC.

I.R.C. § 6001 requires every person liable for any tax imposed under Title 26 to keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe. Treas. Reg. § 1.6001-1(a) provides, in relevant part, that any person subject to tax under subtitle A of the I.R.C., or any person required to file a return of information with respect to income, shall keep such permanent books of account or records as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax or information. Under this authority, the Service may require a taxpayer to substantiate any amount shown on a return, including both the income and expense elements of self-employment income shown on a Schedule C. A taxpayer's failure to substantiate self-employment income allows the Service to disregard such income when determining a taxpayer's eligibility for the EIC and liability for self-employment tax.

Therefore, when a taxpayer who claims the EIC reports net earnings from self-employment with little or no reported expenses and the Service determines that the taxpayer has additional allowable expenses, the Service must subtract these additional expenses to determine the taxpayer's correct net earnings from self-employment. If the Service determines that the taxpayer has additional allowable expenses but is unable to determine the amount of these expenses because of the taxpayer's failure to substantiate them as required by I.R.C. § 6001 and Treas. Reg. § 1.6001-1(a), the Service may disregard the claimed "net" earnings from self-employment when determining the taxpayer's eligibility for the EIC and liability for self-employment tax. If the Service determines the business does not exist, the Service must disregard the claimed net-earnings from self-employment. If such a determination is made, the Service should consider imposition of penalties, up to and including the fraud penalty imposed under I.R.C. § 6663.

If it is determined that the net earnings from self-employment should be adjusted, thereby reducing or eliminating the earned income credit, we draw your attention to I.R.C. §32(k). Section 32(k)(1)(B)(i) disallows the EIC for a period of ten years in cases where the taxpayer's claim for the EIC was due to fraud. Section 32(k)(1)(B)(ii) disallows the EIC for a period of two years in cases where the taxpayer's claim for the EIC was due to reckless or intentional disregard of rules and regulations (but not due to fraud). Section 32(k)(2) provides that in the case of a

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taxpayer who was denied the EIC for any taxable year as a result of the deficiency procedures under subchapter B of chapter 63, no EIC will be allowed for any subsequent taxable year unless the taxpayer provides such information as the Secretary may require. See §1.32-3T.

If you have any further questions, please call (202) 622-6060.

MARY OPPENHEIMER
Assistant Chief Counsel
(Employee Benefits and
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By: _____
MARK SCHWIMMER
Branch Chief
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