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CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE SERVICE CENTER ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL - AUSTIN (SMALL BUSINESS
SELF EMPLOYED) CC:SB:6:AUS
Attn: Jerry Hamilton

FROM: Assistant Chief Counsel (Administrative Provision and
Judicial Practice)
CC:PA:APJP

SUBJECT: Frozen Refunds and Earned Income Credits

This responds to your request for Significant Service Center Advice dated November 21, 2000, in connection with a question posed by the Austin Customer Service Center. The Austin Customer Service Center has requested advice and assistance in interpreting a guideline appearing on the Taxpayer Service Electronic Bulletin Board, TEBB 00027, relating to Significant Service Center Advice, 1998-0032. The issues relate to the disallowance periods under I.R.C. § 32(k) for Earned Income Tax Credit (EITC) and the imposition of the accuracy-related penalty under section 6662 or the fraud penalty under section 6663 for fraudulent or reckless claims of EITC.

Issues

1. Whether the Service can impose the two or ten-year disallowance period for claiming EITC, as provided under section 32(k)(1)(B), without imposing a penalty under either section 6662 or section 6663.
2. Whether there is an underpayment for purposes of imposing the penalties under section 6662 or section 6663 when a claim for EITC is frozen and subsequently disallowed.

Conclusions

1. A final determination of fraud or reckless or intentional disregard of rules and regulations must be made prior to imposing the ten-year or two-year disallowance period under section 32(k)(1)(B). The statute does not require that a fraud or accuracy-related penalty be asserted in order to deny the credit for a period of years. Thus, all that is needed is a determination of fraud or reckless or intentional disregard of rules and regulations for purposes of section 32(k)(1)(B).
2. We have reconsidered our prior advice and determined that a frozen EITC refund, which is subsequently disallowed, is considered an underpayment for purposes of imposing the accuracy-related penalty under section 6662 or the fraud penalty under section 6663.

Discussion

Issue 1: Imposition of Disallowance Period Under Section 32

Section 32 provides, in part, an earned income tax credit (EITC) can be used by eligible individuals against their income tax. The EITC under section 32 is a refundable credit. See I.R.C. § 6401(b)(1).

Section 32(k) imposes a disallowance period for use of EITC for any individual who makes a fraudulent or reckless claim of an EITC. Section 32(k)(1)(B)(i) denies the credit for a period of ten taxable years after the most recent taxable year for which there was final determination that the taxpayer's EITC claim was due to fraud. Section 32(k)(1)(B)(ii) denies the credit for a period of two taxable years after the most recent taxable year for which there was a final determination that the taxpayer's EITC claim was due to reckless or intentional disregard of rules and regulations.

Thus, for the ten-year denial, there must be a determination of fraud, and for the two-year denial, there must be a determination of reckless or intentional disregard of rules and regulations. The statute does not require that a fraud or accuracy-related penalty be asserted in order to deny the credit for a period of years.

In explaining the provision, the Conference Committee stated that "a taxpayer who fraudulently claims the earned income credit (EIC) is ineligible to claim the EIC for a subsequent period of ten years. In addition, a taxpayer who erroneously claims the EIC due to reckless or intentional disregard of rules or regulations is ineligible to claim the EIC for a subsequent period of two years. These sanctions are in

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addition to any other penalty imposed under present law. The determination of fraud or of reckless or intentional disregard of rules or regulations are made in a deficiency proceeding (which provides for judicial review).” See Conf. Rep. 105-220, 105th Cong., 1st Sess. 597 (1997).

Because section 32(k) itself does not mention penalties, we view the language “these sanctions are in addition to any other penalty imposed under present law” as clarifying that the sanctions are not in lieu of dollar penalties. Thus, both the sanction and a penalty apply. There is no suggestion that the sanction applies only if a penalty applies.

Accordingly, there need not be an assessment (or determination) of section 6662 penalty or 6663 penalty to apply the sanctions under section 32(k)(1)(B). A sanction under section 32(k)(1)(B) applies where a determination is made that the taxpayer’s EITC claim was due to fraud or to reckless or intentional disregard of rules and regulations.

Issue 2: Definition of Underpayment for Purposes of Sections 6662 and 6663

Section 6662(c) imposes an accuracy-related penalty in the amount of 20 percent of an underpayment attributable to negligence or disregard of rules or regulations.

Section 6663(a) imposes a fraud penalty in the amount of 75 percent of an underpayment attributable to fraud.

Section 6664(a) defines underpayment as the amount by which the tax imposed exceeds the excess of the sum of (1) the amount shown as the tax by the taxpayer on his return, plus (2) amounts not so shown previously assessed (or collected without assessment), over (3) the amount of rebates made.

The definition of underpayment is also expressed under Treas. Reg. § 1.6664-2(a)(2) of the regulations as:

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

Where 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); and Z = the amount of rebates made.

Section 1.6664-2(b) provides that the “amount of income tax imposed” means the amount of tax imposed on the taxpayer by the Service. This amount is determined

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without regard to (1) credits or payments under section 31 (relating to tax withheld on wages) and section 33 (relating to tax withheld at source on nonresident aliens and foreign corporations); (2) payments of tax or estimated tax by the taxpayer; (3) a credit resulting from amounts assessed under section 6851 as the result of a termination assessment, or section 6861 as the result of a jeopardy assessment; and (4) tax not required to be assessed on the return (such as the tax imposed by section 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. This amount is determined without regard to the items listed in sections 1.6664-(2)(b)(1), (2), and (3)(as listed in above paragraph). However, unlike the computation of the “amount of income tax imposed” in section 1.6664-2(b), this amount is reduced by any overstated prepayment credits claimed on the return. Overstated prepayment credits include overstated withholding under sections 31 and 33, estimated tax payments, and any other payment made by the taxpayer for the 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. These amounts include termination assessments and jeopardy assessments.

Section 1.6664-2(d) also provides that the amount “collected without assessment” means the total of the amounts allowable under sections 31 and 33 credits, estimated tax payments, and other payments, exceed the tax, provided the excess has not been refunded to the taxpayer. Generally, this includes a refund claimed on the return that has not been issued pending an examination.

Section 1.6664-2(e) defines “rebate” as abatements, credits, refunds or other repayments made on the ground that the tax imposed was less than the excess of the sum of the amount shown on the return, plus, amounts not so shown previously assessed (or collected without assessment), over rebates previously made.

Sections 1.6664-2(b), and (c)(1) do 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 sections 1.6664-2(b) and (c). Both of these subsections state the calculations are to be made “without regard” to the sections 31 and 33 credits, estimated tax payments, and other payments. This would suggest that the “amount of tax imposed” and the “amount shown as the tax by the taxpayer on his return” should be computed “with regard” to other refundable credits, such as section 32, when determining the underpayment amount.

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In addition, section 1.6664-2(d) relating to amounts “collected without assessment,” does not address how to factor section 32 credits that are in excess of tax shown on the return, provided such amount has not been refunded. However, it does provide that only section 31 and 33 credits and other payments are taken into account. Section 32 is not considered a payment, it is actually considered part of the tax. Thus, the disallowance of EITC under section 32 is not included in an amount collected without assessment, whether the EITC is refunded or frozen.

Based on this analysis, whether a refund is issued or frozen for a claim of EITC is disallowed, if the audit results in a disallowance of the EITC the underpayment is computed as follows: (1) the “amount of income tax imposed” includes a reduction for the correct amount of the EITC; (2) the “amount shown as tax by the taxpayer on his return” is reduced by the EITC shown on the return; and (3) the amount “collected without assessment” is calculated without taking into account any EITC. Thus, for purposes of calculating an underpayment when there is a EITC disallowed, the underpayment amount should be the same whether the refund was issued or frozen.

The following examples show how to calculate the amount of an underpayment under section 6664 when EITC is disallowed. In these examples, when a refund is frozen it is only for the amount of the disallowed EITC not the amount of any additional refund related to withholding credits.

Example 1:

Taxable Income Shown on Return	\$15,000
Tax Imposed (determined by Service)	\$15,000
Tax Shown on Return	\$2,000
Tax Imposed (determined by Service)	\$2,000
Withholding Credits Shown on Return	\$2,500
Correct Withholding (determined by Service)	\$2,500
EITC Shown on Return	\$800
Correct EITC (determined by Service)	\$0
Refund Shown on Return	\$1,300
Correct Refund (determined by Service)	\$500

The underpayment amount is calculated as follows:

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Underpayment = tax imposed - (tax shown on return - EITC shown on return)
 Underpayment = \$2000 - (\$2000 - \$800)
 Underpayment = \$800

Example 2:

Taxable Income Shown on Return	\$15,000
Tax Imposed (determined by Service)	\$15,000
Tax Shown on Return	\$2,000
Tax Imposed (determined by Service)	\$2,000
Withholding Credit Shown on Return	\$1,800
Correct Withholding (determined by Service)	\$1,800
EITC Shown on Return	\$800
Correct EITC (determined by Service)	\$200
Refund Shown on Return	\$600
Correct Refund (determined by Service)	\$0

The underpayment is calculated as follows:

Underpayment = (tax imposed - correct EITC) - (tax shown on return - EITC shown on return)
 Underpayment = (\$2000 - \$200) - (\$2000 - \$800)
 Underpayment = \$1800 - \$1200
 Underpayment = \$600

If you have any questions or concerns regarding this response, please contact Brad Taylor at (202)622-4940.

CURTIS G. WILSON

By:

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Branch 3

cc: Office of Interest and Penalty Administration