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

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MEMORANDUM FOR JEFFREY J. BASALLA
DIRECTOR, FILING AND PAYMENT COMPLIANCE S:C:CP:FP

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

SUBJECT: Proposed Assessments Using Schedule K-1 Income in the Automated Substitute for Return (ASFR) Program

This is in reply to your request for assistance dated April 10, 2001, concerning the preparation of an IRC § 6020(b) substitute for return using information from a Schedule K-1, Partner's Share of Income, Credits, Deductions, etc.(Form 1065).

Issue

Whether a notice of deficiency issued for a nonfiler that is supported by a proposed assessment based on a substitute for return prepared by the Service showing all the income and gains from a Schedule K-1, but not showing any deductions, losses, or credits is valid and, moreover, will be presumed correct and leave the burden of going forward with evidence on the taxpayer?

Conclusion

A notice of deficiency issued for a nonfiler that is supported by a proposed assessment based on a substitute for return prepared by the Service showing all the income and gains from a Schedule K-1, but not showing any deductions, losses, or credits is valid. The notice will be presumed correct and leave the burden of going forward with evidence on the taxpayer.

Background

The Service identifies taxpayers who have not filed individual income tax returns by comparing filings with information returns documents sent directly to the Service by banks, insurance companies, casinos and state governments, as well as partnerships and trusts. If these information returns reflect enough income that a taxpayer should

have filed a tax return, but did not, the Service will send the taxpayer a "nonfiler" notice. This notice asks that the taxpayer either file the return, or explain why he or she doesn't need to file. If the taxpayer doesn't respond, the Service will send a second "nonfiler" notice.

If a taxpayer does not respond to the "nonfiler" notices, the Service prepares a "substitute for return" for the taxpayer. The determination of how much the taxpayer owes is based on any available third party information and a computer program generates the substitute return. IRM 5.1.11.8.0, Substitute for Returns (5-27-1999). See also, IRM 21.8.2.7.122(1), Computing Taxable Income (12-01-2000).[1] A substitute for return prepared for a nonfiler typically uses the single or married filing separately filing status and allows only one personal exemption and a standard deduction based on that filing status. The inclusion of information from Schedule K-1 in this process is new. When using a Schedule K-1, the Service includes all lines showing income and gains, but not any lines showing losses, deductions, or credits.

The ASFR function sends the taxpayer a letter proposing an amount to be assessed. The 30-Day Letter package is fully automated. IRM 21.8.2.7.128(1), Letter 2566 SC/CG (30-Day Letter Package)(12-01-2000). The letter states that the computation does not give full credit for exemptions, deductions or credits and advises that the best course of action is to file your own tax return. IRM 21.8.2, ASFR Program, Exhibit 21.8.2-2, 30-Day Letter Package Supplement (12-01-2000). The letter informs the taxpayer that the taxpayer has 30 days to file a return, sign a consent (i.e., Form 870) waiving the restrictions on assessment, to explain why the taxpayer is not required to file, or to administratively appeal the proposed assessment. Attached to the letter are an explanation of proposed adjustments and a tax calculation summary report.

The IRM provides directions for acting on taxpayer responses to the letter. For example, changing of filing status from single or married filing separately to married filing joint generally is allowed. IRM 21.8.2.7.175, Change of Filing Status (12-01-2000). Additional exemptions may be allowed. IRM 21.8.2.7.179, Exemptions (12-01-2000). The standard deduction may be increased by claiming a different filing status. IRM 21.8.2.7.180, Standard Deduction (12-01-2000). Itemized deductions may be claimed. IRM 21.8.2.7.181, Itemized Deduction (12-01-2000).

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[1] The manual for ASFR has been moved to IRM 5.18.1 for the 2002 filing season. In this memorandum we will refer to the last published manual, IRM 21.8.2, for a description of the program.

If the taxpayer does not respond to that notice, the Service then sends a statutory notice of deficiency to the taxpayer giving the taxpayer 90 days to file a petition in Tax Court or agree with the assessment. If the taxpayer does not respond to this "90-day letter," the case will then go forward for assessment and issuance of collection notices.

Discussion

IRC § 6020(b)(2) provides that a substitute for return prepared by the Service is "prima facie good and sufficient for all legal purposes." Despite the "all legal purposes" language, the amount shown as due must be assessed under the deficiency procedures pursuant to IRC §§ 6211-6214, and the substitute for return does not start the statute of limitations on assessment under IRC § 6501. However, a deficiency determination based on a substitute for return under IRC § 6020(b) shifts the burden to the taxpayer to establish that the Service's determination of tax liability is incorrect.

The general rule is that the Commissioner's deficiency determination is presumed to be correct, and that the petitioner has the burden of proving it to be wrong." Welch v. Helvering, 290 U.S. 111 (1933). See also T.C. Rule 142(a). The courts have placed a condition on the presumption of correctness of a deficiency notice in the case of unreported income. The condition was put in place because of the difficulty that the taxpayer bears in proving the nonreceipt of income. See, Portillo v. Commissioner, 932 F.2d 1128, 1134 (5th Cir. 1991), revg. in part, affg. in part and remanding T.C. Memo 1990-68. In unreported income cases, courts have held that the presumption of correctness will not arise when a taxpayer shows that the Commissioner's determination of deficiency is 'arbitrary and excessive,' i.e. without factual foundation or lacking in rational basis. See e.g. Gerardo v. Commissioner, 552 F. 2d 549 (3d Cir. 1977); Weimerskirch v. Commissioner, 596 F.2d 358 (9th Cir. 1979); Carson v. United States, 560 F.2d 693 (5th Cir. 1977). In cases where a taxpayer seeks to apply this exception, the taxpayer has the burden of producing some reasonable evidence which demonstrates the arbitrary nature of the notice. Once the taxpayer produces evidence of arbitrariness, the Commissioner must demonstrate the link to income producing activity to ensure that he is entitled to the benefit of the presumption of correctness. A third party information return generally provides this predicate evidence, although the Service may have to contact the third party payor if the taxpayer disputes the receipt of the income.[2]

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[2] In general, third party information returns such as Forms 1099 have some evidentiary value because they are submitted under penalties of perjury and incorrect information may trigger penalties. The Service checks to ensure that the Form 1099 information is reliable. For example, the Service, before attributing any mismatches to unreported income, verifies that the information document is in the proper format and contains the correct name and identification number. The Service also checks to

While a determination of tax liability by the Service must be reasoned and considered in order to be presumed correct, a notice of deficiency does not have to state the basis for the determination or how the deficiencies were determined. Powers v. Commissioner, 100 T.C. 457, 475 (1993). But see Shea v. Commissioner, 112 T.C. 183 (1999), nonacq. 2000-44 IRB 429. In the ordinary case, a court imposes this burden of proof on the taxpayer without looking behind the notice of deficiency to examine it for the motives or methods that were used by the Service in arriving at the deficiency determination. Greenberg's Express, Inc. v. Commissioner, 62 T.C. 324 (1974). The Service is not required to use its authority to make a substitute for return under IRC § 6020(b) for a nonfiling taxpayer before issuing a notice of deficiency. Roat v. Commissioner, 847 F2d 1379 (9th Cir. 1988). However, the preparation of a substitute for return should ensure that any notice of deficiency prepared based on that return will be a reasoned and considered determination.

A substitute for return prepared pursuant to IRC § 6020(b) must meet three requirements. First, the substitute for return must contain taxpayer identifying information, including the taxpayer's name, address and social security number. Second, the substitute for return must contain sufficient data to compute the taxpayer's

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determine whether the taxpayer misclassified the information on the income tax return. Further, the Service verifies whether the payor appears on a list compiled by the Service of payors whose information returns have been verified as erroneously filed or processed. In addition, the Form 1099 is prepared in the normal course of a business activity of a generally unrelated third party. The Schedule K-1 might be differentiated from the Form 1099 in some instances because of the relationship between the parties; nevertheless, such a relation may increase the reliability of the Schedule K-1 as to the income actually reported thereon.

If a taxpayer disputes receipt of the income, the Service contacts the third party payor to determine the correctness of the information provided before issuing a statutory notice of deficiency. This procedure is now mandated by IRC § 6201(d) which provides that in any court proceeding, where the taxpayer "asserts a reasonable dispute" with an item reported on an information return, and the taxpayer has "fully cooperated with the Service," the Service has the burden of producing "reasonable and probative information concerning such deficiency in addition to such information return." IRM 35.4.16.14 (5), Motions to Shift the Burden of Proof (03-26-1997). A nonfiler has not satisfied the requirements of IRC § 6201(d). See, McQuatters v. Commissioner, T.C. Memo 1998-88 ("Section 6201(d) does not provide a means for a taxpayer to avoid his Federal income tax liabilities by failing to file a tax return, refusing to provide any information to the Commissioner or the Court, and refusing to provide any records concerning his income").

liability.[3] Third, the Secretary or his delegate must sign the substitute for return. Hartman v. Commissioner, 65 T.C. 542, 545-6 (1975). IRM 35.4.27.2, citing Millsap v. Commissioner, 91 T.C. 926, 930 (1988). See also Hartman v. Commissioner, 65 T.C. 542, 545-546 (1975). Generally, a substitute for return prepared for the ASFR program and accompanied by a signed thirty day letter constitutes a valid IRC § 6020(b) substitute for return.[4] At issue in the subject case is whether the substitute for return adequately discloses the data from which the tax can be computed if it does not take into account the losses, deductions, and credits shown on the Schedule K-1.

In general, deductions are a matter of legislative grace that a taxpayer must establish he or she is entitled to. New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934). The Service's position is that, in a deduction case, the burden of proof never shifts to the Service. The taxpayer is the party who holds all the information in support of the claimed deductions, and he or she should be required to produce it for the court if he or she expects the claim to be sustained. Indopco, Inc. v. Commissioner, 503 U.S. 79, 84 (1992). IRM 35.4.16.14(6), Motions to Shift the Burden of Proof (03-26-1997).

As indicated above, the Service uses the Schedule K-1 to provide predicate evidence concerning the taxpayer's apparently unreported partnership income. Determining the proper treatment of the deductions, losses, and credits on the Schedule K-1 is not, however, as simple as copying an amount from an information return.[5] In some situations, the Service could examine the Schedule K-1 and find from

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[3] A "dummy return" generated to open up an account for the taxpayer on the master file (normally, the first page of a Form 1040 containing the taxpayer's name, address and social security number) is not an IRC § 6020(b) substitute for return.

[4] The form of the IRC § 6020(b) substitute for return is not important. A "dummy return" accompanied by other documents that satisfy the second and third requirements listed above is a valid IRC § 6020(b) substitute for return.

[5] The Schedule K-1 aids the partner in satisfying the direction in IRC § 702(a) to take into account separately his distributive share of the six items specified therein and other items of income, gain, loss, deduction or credit, to the extent provided by regulations prescribed by the Secretary, as well as taxable income exclusive of these items requiring separate computation. The instructions for Schedule K-1 direct the partner as to where the separately stated items should be shown on the partner's income tax return. These instructions caution that "The amount of loss and deduction that you may claim on your tax return may be less than the amount reported on Schedule K-1. **It is the partner's responsibility to consider and apply any applicable limitations**." Partner's Instructions for Schedule K-1 (Form 1065) under "General Instructions - Purposes of Schedule K-1." The instructions explain that the items shown on the Schedule K-1 do not reflect limitations on losses or adjustments

the face of the schedule, or from information provided with the partnership return, or from other information returns, that the taxpayer is entitled to a deduction, loss, or credit. This case by case approach would not resolve the treatment of all items on the Schedule K-1 in every case and in those cases the Service would be left with a finding that it is simply likely that the taxpayer is entitled to a deduction, loss, or credit. Even in cases in which the limited information before the Service (the Schedule K-1, the partnership return, or other information returns) indicates an item is allowable, to be absolutely certain of a finding, the Service would have to consider the taxpayer's entire activity for the tax year. We do not believe that the Service should have to forgo the ASFR program and undertake, in effect, an examination in order for the Service to issue a valid notice of deficiency with the burden of proof remaining on the taxpayer as regards deductions, losses, and credits where the taxpayer has not filed a tax return.

While we have found no case on point concerning the Service's obligations in the above situation, we believe the obligation may be compared to that in the situation where a taxpayer is faced with a final determination by the Service that disallows deductions; yet, the taxpayer does not attempt to substantiate deductions. In the substantiation situation, it is recognized that a taxpayer in trade or business generating income ordinarily has business and other deductions and that even though a taxpayer has a general recordkeeping requirement under IRC § 6001 to establish the amount of a deduction, where the records are inadequate or there are no records, courts may allow a deduction based on a reasonable estimate; i.e., see Cohan v. Commissioner, 39 F.2d 540, 543-544 (2d Cir. 1930). Nevertheless, if a taxpayer provides no rational basis upon which estimates of deductible expenses may be made, no amount will be allowed even though it may be obvious that some deductible expenses must have been incurred. See Vanicek v. Commissioner, 85 T.C. 731, 742-743 (1985), acq. AOD 1986-038. As to the Service's obligations in the substantiation situation, the Ninth Circuit stated the following in Clapp v. Commissioner, 875 F.2d 1396, 1403 (9th Cir. 1989):

> It may be, as appellants assert, that the Commissioner could have verified the deductions as ordinary and necessary business expenses through reports filed with the IRS and other governmental agencies. It would nevertheless be unwise to place such a burden on the Commissioner when faced with taxpayers who refuse to cooperate or provide the necessary information at their audit examinations. The Commissioner points out that it was taxpayers' duty to substantiate their deductions at the time of the audit examination and that the taxpayers failed to do so.

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that may be required because of the basis rules (which may affect deductions and losses), the at-risk limitations (which may affect deductions and losses), and the passive activity limitations (which may affect losses and credits).

Accordingly, until the taxpayer shows how he or she believes the separately stated items should be reported on an income tax return, the Service should not concede a deduction, loss, or credit on the substitute for return. The ASFR program provides the taxpayer with the opportunity to satisfy his or her initial burden regarding deductions, losses, and credits by responding to the initial notices sent by the Service before the preparation of the substitute for return, or to the 30-day letter proposing the deficiency as well as to the statutory notice of deficiency (90-day letter). It is expected that the correspondence with the taxpayer will result in the taxpayer satisfying its filing requirement and with the Service being provided with the information needed to make a final determination without the expense of, in effect, examining the taxpayer's tax year. Once the taxpayer provides the information, it can be expected that the ASFR program will accept the filing. However, if a question arises, the filing would be forwarded to another function for further consideration and that function would provide a reasoned and considered determination if it becomes necessary to deny an item.

If you have any questions regarding this memorandum, please contact John M. Moran on (202) 622-7697.

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