Office of Chief Counsel
Internal Revenue Service
memorandum

date: February 12, 1998

to: Acting National Director, Compliance Research CP:R

from: Assistant Chief Counsel (Income Tax and Accounting) CC:DOM:IT&A

subject: Request for Opinion -- Strategy to Improve Compliance With Self-Employment Tax Requirements

This is in reply to your memorandum dated December 19, 1997, regarding a planned national strategy to improve the methods used to identify and audit taxpayers who are subject to, but who do not pay, the self-employment (SE) tax.

ISSUES

1. Does the Service have the authority to send an educational letter to taxpayers during service center pipeline processing informing them of a potential SE tax liability if the original return indicates that the SE tax may be due?

2. If the Service has the authority to send the educational letter, would the Service be required to pay interest if a taxpayer's refund is delayed until after the interest-free period specified in section 6611(e) of the Internal Revenue Code?

3. Does the Service have the authority to freeze a taxpayer's refund during return processing if the taxpayer fails to explain why the income is not subject to the SE tax or provide a Schedule SE or does not respond as a result of the educational letter?

CONCLUSIONS

1. The Service has the authority to send an educational letter to taxpayers during return processing informing them of a potential SE tax liability and the procedures for paying the SE tax.

2. The Service would be required to pay interest on a taxpayer's refund that is delayed until after the interest-free period specified in § 6611(e). A return that reports self-employment income, but does not report SE tax and have a Schedule SE attached, is processible within the meaning of § 6611(g)[1].

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[1] Section 6611(h) was renumbered as § 6611(g) by the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1055(b)(2)(D).

3. The Service is permitted to "freeze" a taxpayer's refund pending a response to the educational letter.

FACTS

The Kansas-Missouri District Office of Research and Analysis (DORA) conducted a review of the self-employment tax (SET) inventory. The SET inventory consists of taxpayers who file Forms 1040 that disclose income that may be from self-employment (i.e., that show income on Schedule C, Schedule F, and/or report Other Income), but that do not have Schedule SE attached to the return and that do not include a payment of the SE tax. These returns are assigned a "V" audit code by the Martinsburg Computing Center.

The Kansas-Missouri DORA conducted a compliance test of taxpayers whose returns were included in the SET inventory by sending an educational letter to a sample of those taxpayers. The educational letter provided the taxpayer with information about the SE tax, including Schedule SE and its instructions. Taxpayers were instructed how to send amended returns if the taxpayer owed the SE tax.

As a result of the test, 22 percent of the sample group filed amended returns paying SE tax. The study also found that 40 percent of the taxpayers in the sample group did not owe SE tax.

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We understand that all taxpayers who are assigned a "V" audit code will be sent the educational letter including those who are not owed a refund. If the taxpayer does not voluntarily pay the SE tax then the return will be sent to Examination for processing under normal procedures including issuance of a notice of deficiency if necessary. Refund returns will be sent back to the taxpayer with the letter. Returns that cannot be sent back to the taxpayer will be suspended until a response is received or the 45-day purge date is reached. If the taxpayer does not reply by furnishing a Schedule SE, or does not provide an acceptable explanation of why the income is not subject to SE tax, the refund will be frozen.

DISCUSSION

Issue 1.

Section 1401 imposes a tax for each taxable year on the self-employment income of every individual. Section 1402 defines the net earnings subject to the tax imposed by § 1401.

Section 6201(a) authorizes the Internal Revenue Service to assess any amount of tax determined by the taxpayer as to which a return is required by the Code. Section 6211(a) includes in the definition of a deficiency income taxes imposed by subtitle A. The self-employment tax imposed by § 1401 is included in subtitle A and is therefore subject to the deficiency procedures contained in §§ 6211 through 6216. See also, § 1.1401-1(a), which states that the self-employment tax is levied, assessed, and collected as part of the income tax imposed by subtitle A of the Code and, except as otherwise expressly provided, is included in the tax imposed by section 1 or 3 in computing any deficiency or overpayment.

Section 6213(b) authorizes assessments based on mathematical or clerical errors without the prior issuance of a notice of deficiency. We agree with the opinion of your office that this math error authority is not currently available to implement the planned strategy. The Office of Chief Counsel has previously concluded that the SE tax cannot be assessed as a mathematical or clerical error in situations in which the return discloses self-employment income, but the taxpayer fails to pay the SE tax and does not attach Schedule SE. See G.C.M. 37219, Adjustments to Self-Employment Tax in the Service Centers, I-103-77 (August 10, 1977).

The use of an "educational" letter is not precluded by the deficiency procedures. The educational letter can be sent during service center pipeline processing or at a later date as was the case with the Kansas-Missouri DORA study. If the taxpayer fails to explain that the income is not subject to the self-employment tax, or simply fails to respond, then the taxpayer should be sent a letter explaining the proposed adjustment followed by a notice of deficiency, if necessary.

Issue 2.

Section 6611(b)(1) provides that overpayment interest is allowed and paid, in the case of a credit, from the date of the overpayment to the due date of the amount against which the credit is taken. Section 6611(b)(2) provides that interest is allowed and paid, in the case of a refund, from the date of the overpayment to a date (to be determined by the Secretary) preceding the date of the refund check by not more than 30 days.

Pursuant to § 6611(b)(3), in the case of a return of tax which is filed after the last date prescribed for filing such return (determined with regard to extensions), no interest shall be allowed or paid for any day before the date on which the return is filed.

It is well established that to be considered a return, a form need not be perfectly accurate or complete. A signed form that appears to be an honest attempt to comply with the tax laws and that is in substantial compliance with the law will generally be considered a return by the courts. See Zellerbach Paper Co. v. Helvering, 293 U.S. 172 (1934).

The Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13271, 107 Stat. 312, 541 (OBRA 1993), amended § 6611(e) by enacting subsections (e)(1), (e)(2), and (e)(3). Section 6611(e)(1) replaces § 6611(e) as the general 45-day rule and extends its application to all taxes imposed by the Code and not just income taxes as was the case prior to OBRA 1993. Section 6611(e)(1) states:

> If any overpayment of tax imposed by this title is refunded within 45 days after the last day prescribed for filing the return of such tax (determined without regard to any extension of time for filing the return) or, in the case of a return filed after such last date, is refunded within 45 days after the date the return is filed, no interest shall be allowed under subsection (a) on such overpayment.

Section 6611(g)(1) states that for purposes of §§ 6611(b)(3), 6611(e), and 6611(h), a return will not be treated as filed until it is filed in processible form. Section 6611(g)(2) states that a return is in processible form if (1) the return is filed on a permitted form, (2) the return contains the taxpayer's name, address, identifying number, and the required signature, and (3) the return contains sufficient required information (whether on the return or on required attachments) to permit the mathematical verification of tax liability shown on the return.

A return that discloses a mathematically verifiable income tax liability based on the amount of taxable income shown on the return would generally be processible if the schedules required to support the computation of the income tax liability are attached (assuming the other conditions of § 6611(g) are met). A return that does not report an additional separate SE tax liability and does not have a Schedule SE attached is a processible return even if the SE tax is based on the same income

on which the income tax liability was based. The test of § 6611(g)(2)(B)(ii) is whether there is sufficient required information (whether on the return or on required schedules) to permit the mathematical verification of the tax shown on the return. This rule cannot be invoked in situations in which a separate tax is not shown on the return but the Service has reason to think the additional separate tax is due. In this regard, we note that according to the results of the Kansas-Missouri DORA study 40 percent of the taxpayers in the test group were not liable for the SE tax even though there was self-employment income shown on the return.

Accordingly, if the Service delays the processing of the taxpayer's return beyond the 45-day interest-free period permitted by § 6611(e) pending a response to the educational letter, the Service would be required to pay interest on any refund ultimately paid to the taxpayer. Since the Forms 1040 that comprise the SET inventory would be considered valid returns by the courts, and are processible by the Service, this category of returns should not be sent back to the taxpayer along with the educational letter.

Issue 3.

The strategy to improve compliance with the SE tax also contemplates that the Service may "freeze" refunds during pipeline processing when the taxpayer fails to explain that the income is not subject to the SE tax or fails to reply to the educational letter.

Section 6402(a) provides that, in the case of any overpayment, the Secretary, within the applicable period of limitations, may credit the amount of such overpayment, including any interest allowed thereon, against any liability owed by the taxpayer who made the overpayment and shall, subject to certain authorized offsets, refund any balance to the taxpayer.

There is no requirement in § 6402, its legislative history, or the regulations under § 6402 that overpayments claimed on a return be immediately refunded. See, for example, G.C.M. 36909, Assessments in Case of Mathematical or Clerical Errors, I-456-76 (November 3, 1976). It is also well settled that the Service is not required to make a refund to any taxpayer unless the taxpayer has overpaid the tax liability. See Lewis v. Reynolds, 284 U.S. 281 (1932). An overpayment does not exist if the total amount paid by the taxpayer does not exceed the combined income tax and SE tax liabilities. Therefore, legally the Service can "freeze" a refund if circumstances indicate that an overpayment does not exist.

Circumstances may indicate that an overpayment does not exist if a return shows income that may be self-employment income, but the taxpayer does not pay any SE tax with the return. If the potential SE tax eliminates the overpayment then the Service may hold the refund.

If you have any questions regarding this opinion, or would like to meet to discuss it, please contact John McGreevy on 622-7506.

~~JODY J. BREWSTER~~

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