Office of Chief Counsel
Internal Revenue Service

memorandum

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to: M. K. MORTENSEN, ASSOCIATE AREA COUNSEL
(SMALL BUSINESS/SELF EMPLOYED)
CC:SB:5:SLC
ATTN: MARK H. HOWARD

from: Curt Wilson, Assistant Chief Counsel
Administrative Provisions and Judicial Practice
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subject: Significant Service Center Advice
Form 1041 and Application of IRC Section 6702

This Chief Counsel Advice responds to your memorandum dated September 11, 2002, requesting reconsideration of the position taken in the memorandum issued on August 28, 2002, concerning Form 1041 and application of I.R.C. § 6702. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

ISSUE

Whether Forms 1041, by which purported trusts claim refunds in the amount of social security taxes paid by the putative trust's fiduciary, should be treated as valid returns under I.R.C. § 6011?

CONCLUSION

We believe a reviewing court would probably find the described Forms 1041 "valid" returns under I.R.C. § 6011, unless entries on the returns or attached correspondence negate the intent to file. Regardless of the validity of the return, however, the Service must make an independent business decision on whether to process these documents. We recommend

that the Service generally follow the procedures for processing frivolous claims set forth in IRM section 4.19.1.6.7.4.

FACTS

Since the Service centralized the Frivolous Return Program in Ogden, Utah, in January of 2001, the Service has received numerous Forms 1041 from individuals claiming a refund of all social security taxes paid during their lifetime. Promoters of this scheme advise individuals to request a “lifetime earnings statement” from the Social Security Administration and to request an employer identification number from the Internal Revenue Service (Service) as a basis for preparing the claim. The promoter/return preparer uses these two items to prepare the Form 1041 for the individual and charges the individual a fee. The Form 1041 lists the individual’s name followed by the word “trust,” and the Form 1041 lists the name of the individual filing the form as the fiduciary of the “trust.” It appears the individual enters the lifetime earnings subject to social security tax as the “total income” on the Form 1041 and then claims a deduction for the same amount on the line for “fiduciary fees.” After claiming a deduction for exemptions, the individual reports a negative taxable income and zero tax liability. The individual then reports the lifetime social security withholdings as withholdings on the return and claims a refund for that amount.

Criminal Investigation advises that some but not many of these individuals have created pro forma trust documents. Most, but not all of these Form 1041 claims originate in the Atlanta area.

Your Office advises that Criminal Investigation has transferred a large number of these Forms 1041 to the Ogden Campus, and you expect that the Compliance employees will have over 10,000 of these documents to process. We assume that, based on the identification and collection of these documents by Criminal Investigation, you will be able to show that the trusts are shams.

LAW AND ANALYSIS

In the Significant Service Center Advice issued August 28, 2002, this office concluded that the Service should treat these Forms 1041 as valid returns under I.R.C. 6011, unless entries on the returns or attached correspondence negate the intent to file. You request reconsideration of this position.

We have carefully reviewed your comments, but after consideration of your arguments, this Office reaffirms the position that a reviewing court would probably find the described Forms 1041 “valid” returns under I.R.C. § 6011. In analyzing this issue, it is helpful to examine the existing case law as the issue of what constitutes a valid return is frequently litigated. In an early case addressing the issue, the Supreme Court indicated that a "defective" or "incomplete" return may be sufficient to start the running of the period of limitation if it is a specific statement of the items of income, deductions, and credits in compliance with the

statutory duty to report information. To have such effect, however, the return must honestly and reasonably be intended as such. *Florsheim Bros. Drygoods Co. v. United States*, 280 U.S. 453 (1930).

In *Zellerbach Paper Co. v. Helvering*, 293 U.S. 172 (1934), the taxpayer filed its original income and profits tax return for its fiscal year ending April 30, 1921, in July 1921. Although the Revenue Act of 1921 required taxpayers to file a new or supplemental income and profits tax return if the original return had been prepared pursuant to the provisions of the Revenue Act of 1918 and additional tax was due under the Revenue Act of 1921, the taxpayer did not file a new or supplemental return. When the Commissioner issued a deficiency notice to the taxpayer in May 1928, the taxpayer alleged that the notice was barred because the period of limitations for assessment had expired. The Commissioner argued that the period of limitations for assessment had not begun because the return received from the taxpayer in July 1921 was a nullity. The Supreme Court disagreed and determined that the period of limitations had expired. The Court acknowledged that the taxpayer had not complied with the requirement to file a second return. Nevertheless, the Court held that the original return was sufficient to begin the period of limitations. The Court concluded that, for purposes of the statutes of limitations:

> perfect accuracy or completeness is not necessary to rescue a return from nullity, if it purports to be a return, is sworn to as such, and evinces an honest and genuine endeavor to satisfy the law. This is so even though at the time of filing the omissions or inaccuracies are such as to make amendment necessary.

293 U.S. at 180 (citation omitted). Thus, if a document substantially complies with the requirements for making a return, it is sufficient as a return for purposes of the period of limitations, whether or not such document is flawed. *Id., see also Germantown Trust Co v. Commissioner,* 309 U.S. at 304 (1940) (fiduciary return filed by the taxpayer was a return for purposes of the statute of limitations, notwithstanding that the return was flawed inasmuch as the taxpayer was required to file a corporate return and not a fiduciary return).

The most recent Supreme Court reaffirmation of the test articulated in *Florsheim* and *Zellerbach* is found in *Badaracco v. Commissioner,* 464 U.S. 386 (1984). There, the taxpayer filed a return which he conceded was “false or fraudulent with the intent to evade law.” *Id.* at 393. He later filed a nonfraudulent amended return. The taxpayer argued that the original return, to the extent it was fraudulent, was a nullity for purposes of the statute of limitations. The Court disagreed, noting that the fraudulent original returns:

> purported to be returns, were sworn to as such, and appeared on their faces to constitute endeavors to satisfy the law. Although those returns, in fact, were not honest, the holding in *Zellerbach* does not render them nullities.

Id. at 397.

The lower courts have subsequently synthesized the criteria enunciated by the Supreme Court into the following four-part test for determining whether a defective or incomplete document is a valid return: "First, there must be sufficient data to calculate tax liability; second, the document must purport to be a return; third, there must be an honest and reasonable attempt to satisfy the requirements of the tax law; and fourth, the taxpayer must execute the return under penalties of perjury." *Beard v. Commissioner*, 82 T.C. 766, 777 (1984), *aff'd per curiam,* 793 F.2d 139 (6th Cir. 1986).

This generally accepted formulation of the criteria for determining a valid return is known as the "substantial compliance" standard. If a defective or incomplete document meets the substantial compliance standard, the document is a valid return for purposes of the statute of limitations on assessment and for purposes of determining the failure to file penalty of section 6651(a) of the Code. A document that does not meet the substantial compliance standard is a not a return for purposes of the Code.

As your comments validly point out, the 'honest and reasonable attempt" prong of the substantial compliance standard is the prong where these Forms 1041 would be most vulnerable. Apart from the so-called "tax protestor" cases, *see, e.g., United States v. Smith,* 618 F.2d 280 (5th Cir. 1980) (zeros and constitutional objections); *United States v. Moore*, 627 F.2d 830 (7th Cir. 1980); *United States v. Porth*, 426 F.2d 519 (10th Cir. 1970); *Beard*; *Thompson v. Commissioner*, 78 T.C. 558 (1982); and *Sochia v. Commissioner,* T.C. Memo. 1998-294); there is little authority for determining what constitutes an honest and reasonable attempt to satisfy the requirements of the tax law. Courts, however, have been reluctant to declare defective or incomplete returns as nullities in the absence of protestor language. Cases such as *Badaracco*, *Steines v. Commissioner*, T.C. Memo. 1991-588 (frivolous Schedule C claiming $100 billion loss), and *Nicolaisen v. Commissioner,* T.C. Memo. 1985-120, are typical. As discussed above, although the Supreme Court in *Badaracco*, recognized that the taxpayer filed returns that were fraudulent, the Supreme Court declared them valid for purposes of starting the statute of limitations, noting that "[a]lthough those returns, in fact, were not honest, the holding in *Zellerbach* does not render them nullities." *Badaracco* 464 U.S. at 397. Therefore, despite the fact that a return may erroneously, fraudulently, or frivolously claim a refund for the individual's lifetime social security withholdings, it may still be considered a valid return for purposes of starting the statute of limitations on assessment. See also the cases in which returns that contain a series of zeros were also found to be valid. *United States v. Long*, 618 F.2d 74 (9th Cir. 1980). The Ninth Circuit, in *United States v. Kimball*, 925 F.2d 356 (9th Cir. 1991), subsequently affirmed its position in *Long*. This position has also been adopted by the Eighth Circuit in *United States v. Grabowski*, 727 F.2d 681 (8th Cir. 1984). The opposing authority is represented by *United States v. Smith,* 618 F.2d 280 (5th Cir.), *cert. denied,* 449 U.S. 868 (1980). *See also United States v. Rickman*, 638 F.2d 182, 183-84 (10th Cir. 1980); *United States v. Mosel*, 738 F.2d 157 (6th Cir. 1984).

Under the circumstances, we think that a reviewing court would probably conclude that the Forms 1041 evince an honest and reasonable attempt to satisfy the tax law under the

traditional substantial compliance standard. The documents do not contain overt Constitutional objections to the income tax and are not otherwise characterized by traditional "tax protestor" arguments.

We believe, however, that attached correspondence could affect the determination of whether a return is valid for purposes of processing. In general, we believe that attachments would not affect the determination that the documents in question are returns for processing purposes. However, attachments might contribute to the determination whether the documents meet one of the four factors of the substantial compliance standard cited in *Beard*. For example, in *Williams v. Commissioner*, 114 T.C. 136 (2000), the Tax Court found that an attached disclaimer negated the meaning of a jurat and that the substantial compliance standard was not met.

On the other hand, correspondence attached to the return may be considered protected free speech, in which case courts have taken the view that the validity of the return is unaffected by additional correspondence. *Drefchinski v. Regan*, 589 F. Supp. 1516 (W.D La. 1984). If a Service employee finds correspondence or attachments included with returns which they believe could affect any of the answers in the Service Center Advice, they should seek further advice from appropriate Service personnel.

INDEPENDENT BUSINESS DECISION

Although we conclude that these Forms 1041 likely satisfy the criteria for treatment as "returns" within the meaning of section 6011 of the Code, we recognize that these claims for refund have no substantive merit. Even if taxpayers file refund suits on these claims, they will not be able to prevail in litigation. Accordingly, the Service may make an independent business judgment not to formally process these documents. Your office points out that Compliance employees will have over 10,000 of these documents to process. The Service may decide that its resources and manpower may be better spent engaged in other projects.

We do not believe, however, that these returns should be ignored and not processed solely on the grounds that they are nullities. If these Forms 1041 are not processed in some manner, the Service will not be able to impose the frivolous return penalty under Section 6702 of the Code. In addition, if these Forms 1041 are not processed as claims for refund, it potentially delays the Service having an opportunity to test whether the filing of these Forms 1041 by individuals qualifies as a good faith attempt to comply with the law. The filing of an original document reflecting an overpayment constitutes a claim for refund. Until the Service disallows the claim, the limitations period for filing suit in District Court or the Court of Federal Claims remains open. Finally, processing these returns/claims for refund and entering the data into the Service's Master File system will assist tax administration as the data mining of information in the Master Files is one of the investigative techniques Criminal Investigation uses to uncover trends, and to identify potential subjects for investigation and prosecution.

Processing these Forms 1041 would not preclude the Service from later contending that the return is invalid after the claim for refund has been denied and that individual files a refund action suit. But if these Forms 1041 are not processed, it potentially delays the Service from having an opportunity to test whether the filing of these Forms 1041 by individuals qualifies as a good faith attempt to comply with the law.

The potential delay flows from the fact that, until the Service disallows the claim, the limitations period for filing suit in District Court or Court of Federal Claims remains open indefinitely, thus creating a disincentive for the individual to sue promptly. Therefore, if the business decision is made to process these documents, we recommend that the Service issue a formal notice of claim disallowance, as provided by I.R.C. § 6532(a)(1), to start the limitations period running. Once the notice of claim disallowance is issued, the individual has two years to challenge the claim disallowance in court.

We also note that procedures for employees filing claims for refund under the Federal Insurance Contributions Act (FICA) are set forth in Treas. Reg. § 31.6402(a)-2(b) have not been followed here. The regulation provides that an employee may file a claim for refund of FICA taxes erroneously withheld by his employer if (1) the employee is not reimbursed by his employer for the erroneously withheld tax, (2) the employee does not authorize the employer to file a claim for refund, (3) the employee has not claimed the amount of overwithheld FICA taxes as a credit against his income tax liability, and (4) the overcollection cannot be corrected under the rules of Treas. Reg. § 31.3503-1, which permit erroneously withheld FICA taxes to be applied against an employee's liability, if any, for taxes due under the Railroad Retirement Tax Act. The refund claim must include a statement by the employee which sets forth whether he has claimed any portion of the overcollection as a credit against income tax liability, and must include a statement obtained, if possible, from the employer, setting forth the extent, if any, of any overpayment which has been claimed as a refund by the employer or authorized by the employee to be so claimed. If the employer does not furnish the employee with such a statement, the employee's refund claim must set forth the facts to the best of the employee's knowledge and explain the employee's inability to obtain the statement from his employer. Treas. Reg. 31.6402(a)-2(b)(2). The failure to comply with these procedures may provide an alternative basis for disallowing the claim.

Accordingly, if the business decision is made to process these documents, we recommend that the Service generally follow the procedures for processing frivolous claims set forth in IRM section 4.19.1.6.7.4. The Service should:

1. Send a letter informing the individual of their frivolous position (including Publication 2105) and include Form 2297, Waiver of Statutory Notification of Claim Disallowance, and Form 3363, Acceptance of Proposed Disallowance of Claim for Refund or Credit, to allow rescission of the frivolous claim. The letter should invite the individual to present proof that the trust filing the document and making the refund claim is not a sham.

2. If a response is received with both forms signed, disregard the previous filings and attach forms to original returns. In this situation, do not assess the frivolous return penalty. Update the inventory record with closure. Close case controls.

3. If no response or a frivolous response is received, assess the frivolous return penalty against the individual. Send Letter 105C, Claim Disallowed, using penalty claim disallowance procedures (see IRM 21.8.1.4.4, Claims Processing).

4. File the case under TC290 DLN and update the inventory record with closure. History TXMOD 105CSent and close the case.

5. Frivolous responses to 105C letters should be associated with the case file under the TC290 DLN.

Your office contends that the acceptance of these Forms 1041 will create additional practical problems because it will increase the likelihood that the Service will issue erroneous refunds with the practical problems of collecting these refunds. We recognize your concerns, and if the business decision is made to process these returns, we recommend that the Service put in place safeguards to make sure that erroneous refunds are not issued in these cases. Accordingly, if the Service decides to process these documents, we recommend that the Service take appropriate steps to adjust the accounts of the affected individuals. Do not credit the individual's account when processing the return. In cases where the Service has not issued refunds, and the Service has entered a credit amount and the appropriate freeze code on the individual's account to ensure that the claimed overpayment was not refunded, the Service should reverse the reported prepayment credits (withholding) on the account. This action would bring the individual's account into balance since the reported tax liability on the return was zero and the prepayment credits, after the reversal, are zero. A zero balance in the account would help prevent the accidental lifting of the freeze code that causes the issuance of an erroneous refund.

Finally, we believe it is important these returns/claims for refund be processed and the data entered into the Service's Master File system. Criminal Investigation advises that data mining of information in the Master Files is one of these investigative techniques they use to uncover trends, and to identify potential subjects for investigation and prosecution.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call if you have any further questions.