

Office of Chief Counsel
Internal Revenue Service

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memorandum

CC:EBEO:Branch 4
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to: District Counsel, Brooklyn CC:NER:BRK
ATTN: Patricia Riegger

from: Associate Chief Counsel (Employee Benefits and
Exempt Organizations CC:EBEO

ment Income

and the Earned Income Credit TL-N-821-95

This responds to your undated request for Significant Advice in connection with questions posed by the Chief, Examination Branch at the Brookhaven Service Center (Service Center) about the disregarding of net-earnings from self-employment. Your request was forwarded by an electronic mail message dated March 30, 1997. As explained below, we agree with the conclusions reached in your request for Significant Advice.

Disclosure Statement

Unless specifically marked "Acknowledged Significant Advice May Be Disseminated" above, this memorandum is not to be circulated or disseminated except as provided in CCDM (35)2(13)3:4(d) and (35)2(13)4:(1)(e). This document may contain confidential information subject to the attorney-client and deliberative process privileges. Therefore, this document shall not be disclosed beyond the office or individual(s) who originated the questions discussed herein and are working the matter with the requisite "need to know." In no event shall it be disclosed to taxpayers or their representatives.

Issue

Whether, in determining the amount of earned income credit available to a taxpayer, the Service can disregard reported net earnings from self-employment based upon lack of substantiation or failure to keep proper records.

Conclusion

Based on the facts described below, the Service can request the necessary books and records to substantiate the reported net earnings from self-employment. If the net earnings from self-employment are not substantiated, the net earnings from self-employment can be disregarded, thereby eliminating the amount of the earned income credit available to a taxpayer.

Facts

The Service Center Criminal Investigation Branch has referred a large number of Forms 1040 to the Service Center Examination Branch. The Forms 1040 all report an amount of net earnings from self-employment that would maximize the taxpayer's earned income credit. The earned income credit reported on the taxpayer's Form 1040 is large enough to cover the self-employment tax due by the taxpayer as well as generate a sizable refund. The businesses listed on the taxpayer's Schedule C are usually those that involve small cash transactions, with little or no expenses claimed against gross receipts (e.g., hair braiding and babysitting). In a large number of cases, based on the similarity of the handwriting, it appears that many returns are being submitted by a single preparer, although none of the returns is signed by a preparer.

Examination has indicated it intends to conduct examinations of these returns. If no response is received to their request for substantiation of the gross receipts, the net earnings from self-employment reported on Form 1040 would be disregarded. This would cause the earned income credit to be disallowed.

Discussion

Internal Revenue Code section 32 provides for a refundable credit to taxpayers based upon a percentage of the taxpayer's earned income. Section 32(c)(2)(A) defines "earned income" as (i) wages, salaries, tips and other employee compensation, plus (ii) the amount of the taxpayer's net earnings from self-employment for the taxable year (within the meaning of section 1402(a)), but such net earnings shall be determined with regard to the deduction allowed to the taxpayer by section 164(f). Net earnings from self-employment is defined in section 1402(a), in relevant part, as "the gross income derived by an individual 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..."

Because the earned income credit is calculated as a percentage of the taxpayer's earned income, it is essential to determine the taxpayer's correct earned income (which consists of net earnings from self-employment under your facts) in order to determine the taxpayer's correct amount of the earned income credit.

You correctly state that while it is generally counter-intuitive to question whether a taxpayer has over reported net earnings from self-employment, it is necessary in cases such as these. This is because the amount of the earned income credit varies depending upon the amount of the taxpayer's net earnings from self-employment. Thus, if the taxpayer has no net earnings

from self-employment, the earned income credit would not be available. If the taxpayer has net earnings from self-employment, but in an amount greater than that reported, the earned income credit may be reduced or eliminated.

Section 6001 requires every person liable for any tax imposed by 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. Section 1.6001-1(a) of the Income Tax Regulations provides, in relevant part, that any person subject to tax under subtitle A of the Code, 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 (emphasis added). Thus, if the claimed net earnings from self-employment are not substantiated, they may be disregarded, thereby eliminating the taxpayer's earned income credit.

The IRS Restructuring and Reform Act of 1998 was signed into law on July 22, 1998. It adds section 7491 to the Code, relating to burden of proof in court proceedings. Once certain conditions are satisfied, section 7491 shifts to the Service the burden of proof concerning a factual issue relevant to determining the taxpayer's tax liability. In order for section 7491 to apply, the taxpayer must: (1) introduce credible evidence regarding such factual issue, (2) have complied with the substantiation and recordkeeping requirements of the Code, and (3) have cooperated with reasonable requests by the Service for witnesses, information, documents, meetings, and interviews. The taxpayer has the burden of establishing that each of these conditions are satisfied. If the requirements of section 7491 are not satisfied, the burden of proof is on the taxpayer to prove that the Commissioner's deficiency determination is in error. Tax Court Rule 142(a).

If it is determined that the net earnings from self-employment should be disregarded, thereby eliminating the earned income credit, we wish to draw your attention to Code section 32(k), which is effective for taxable years beginning after December 31, 1996. Section 32(k)(1)(B)(i) disallows the earned income credit for a period of ten years in cases where the taxpayer's claim for the earned income credit was due to fraud. Section 32(k)(1)(B)(ii) disallows the earned income credit for a period of two years in cases where the taxpayer's claim for the earned income credit 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 taxpayer who was denied the earned income credit for any taxable year as a result of the deficiency procedures under subchapter B of chapter 63, no earned income credit will be allowed for any subsequent taxable year

