



OFFICE OF  
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
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INTERNAL REVENUE SERVICE NATIONAL OFFICE  
SIGNIFICANT SERVICE CENTER ADVICE

MEMORANDUM FOR: ASSOCIATE DISTRICT COUNSEL, SALT LAKE CITY  
CC:WR:RMD:SLC

FROM: ACTING ASSISTANT CHIEF COUNSEL  
(INCOME TAX & ACCOUNTING)  
CC:DOM:IT&A

SUBJECT: Significant Service Center Advice  
Questions on Proper Processing of the Philippine Scheme

This responds to your request for significant advice, dated June 29, 1998, in connection with several questions posed by the the Ogden Service Center related to processing of certain returns that incorrectly claim refunds of Social Security payments pursuant to the U.S.-Philippines tax treaty.

ISSUES:

1. A number of such returns were placed in a freeze status because of possible criminal investigation and prosecution. Once the decision has been made not to pursue the matter criminally, how should such returns be processed?
2. With respect to ongoing processing of returns claiming refunds on this basis, do the documents that are filed qualify as "returns," and may a deficiency be assessed using the "math error" procedures?

CONCLUSIONS:

1. The processing of similar returns was discussed in a series of prior service center advisories. The Office of Chief Counsel has recently reconsidered the general question, in conjunction with the Headquarters criminal investigation function, and has reaffirmed the conclusions of those advisories. In connection with processing the present, temporary backlog of inventory, cases for which the assessment limitations period has expired or will shortly expire should be

processed using claim disallowance procedures. As an ongoing matter, however, such cases should be processed within the assessment limitations period, following deficiency rather than claim disallowance procedures in order to preserve the taxpayer's option to contest deficiencies in Tax Court.

2. Generally, the documents in question appear to satisfy the requirements for a "return," even though they may be filed on the wrong form, or lack a valid taxpayer identification number. We question whether the situations you have identified constitute "mathematical or clerical errors" within the meaning of § 6213(g). However, personnel in the examination function at the Ogden Service Center have indicated that the volume of these returns is such that they can process them using normal deficiency procedures so there is no need at present to consider whether some of these returns could be processed using math error authority.

FACTS:

Although the exact fact patterns vary, generally the returns in question involve claims for refund of 30% withholding under §§ 871 and 1441 on social security benefits paid to taxpayers in the Philippines. Such refunds are not allowable under the U.S.-Philippines tax treaty.

Returns claiming refunds under this scheme originate with return preparers in the Philippines. Some of the preparers who file invalid refund claims use Form 1040NR. Generally, such returns are processed at the Philadelphia Service Center, using guidelines in the Internal Revenue Manual. Ogden Service Center personnel believe the instructions used by the Philadelphia Service Center adequately deal with the processing of such claims that are filed on Form 1040NR; however, some of the preparers using this scheme file returns on Form 1040, 1040A, or 1040X, and these may be received and processed at other service centers, such as Ogden.

In addition, as a result of investigations by the Criminal Investigation Division at the Ogden Service Center, an inventory of such cases accumulated, some of which were approaching or had passed the assessment limitation period expiration date. Your questions concern returns as to which the Criminal Investigation Division has decided it will not pursue criminal prosecution.

Typical of the type of returns still being received and processed at the Ogden Service Center is a Form 1040A (1997) that shows the following entries:

line	13a Social Security benefits	4,032
	13b Taxable amount	-0-
	29a Total Federal income tax withheld	1,028
	29d Total payments	1,028
	30 Amount overpaid	1,028

31 Amount to be refunded

1,028

The other lines are blank or contain zeroes. Thus, the only income shown is social security benefits, and the return is essentially requesting a refund of the tax withheld under § 1441. Some returns are filed without a valid taxpayer identification number.

#### DISCUSSION:

1. In a series of advisories, this office considered the proper treatment of returns claiming improper refunds that had been collected in connection with possible criminal prosecution. See Acknowledged Significant Service Center Advice 1997-002 (May 21, 1997); 1997-007 (June 30, 1997); 1998-042 (April 10, 1998; clarifying and superseding SCA 1997-007).

This office has recently reconsidered the issues raised in these memoranda, and has generally confirmed their conclusions.

In particular, with respect to the processing of the temporary, current backlog of cases, we have advised the Director of Investigations (Tax Refund Fraud) that we do not recommend the issuance of notices of deficiency when, because the limitations period for assessment has expired or will shortly expire, the issuance of such notices would not be timely. However, the Service has the authority to refuse to allow a refund or credit -- even without assessment -- of any amount collected within the period of limitations on assessment, on the grounds that there is no true "overpayment" as required by § 6402. See Lewis v. Reynolds, 284 U.S. 281 (1932). Notices of claim disallowance should be issued in such cases in order to advise the taxpayer of the disallowance and the right to contest the matter in a refund forum, and to provide finality by triggering the running of the limitations period under § 6532. See SCA 1998-042, Issue 4.

With respect to cases in which the assessment limitations period is open, however, while the Service has instituted refund holds or freezes in appropriate cases, the Service has not used the authority of Lewis v. Reynolds to substitute claim disallowance procedures for normal deficiency procedures with respect to refunds or credits claimed on original returns -- since to do so would deprive taxpayers of their right to contest deficiencies in Tax Court as an alternative to bringing a suit for refund. Thus, even though no refund is made, normal assessment procedures -- including the "mathematical or clerical error" procedures and the issuance of a notice of deficiency, if necessary -- should be followed. See SCA 1998-042, Issues 1-3.

Unlike the situations considered in these previous advisories, which involved claims for refund of wage withholding or the earned income credit, the present cases involve claims for refund of amounts that were withheld pursuant to § 1441.

However, the same conclusions apply. As in the case of wage withholding, for example, a taxpayer whose liability is satisfied by withholding at source under § 1441 but who files a return asserting a liability of zero still has a "deficiency," within the meaning of § 6211, even though the withholding is not refunded. This is because a "deficiency" is generally based on an understatement of tax, rather than an underpayment of tax, and, as in the case of wage withholding under § 31, the credit for withholding at source on nonresident aliens under § 33 is ignored, under § 6211(b)(1), in defining a "deficiency." Thus, for example, a taxpayer who is liable for \$100 of tax under § 871, and who files a return incorrectly reporting no liability and requesting a \$100 refund, has a deficiency of \$100 -- the difference between the correct tax and the tax shown on the return -- regardless of whether the \$100 § 33 credit is actually refunded.<sup>1</sup>

## 2. (a) Status as a "return."

Generally, the Commissioner has the authority to require taxpayers to file their returns on the correct form; however, a document may qualify as a return so long as it meets certain requirements. See Commissioner v. Lane-Wells, 321 U.S. 219 (1944); Germantown Co. v. Commissioner, 309 U.S. 304 (1940); Zellerbach Paper Co. v. Helvering, 293 U.S. 172 (1934). In Beard v. Commissioner, 82 T.C. 766, 777 (1984), aff'd, 793 F.2d 139 (6th Cir. 1986), the court summarized the relevant Supreme Court case law as follows:

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.

In the present cases, neither the fact that the taxpayer filed on a form other than Form 1040NR, nor the fact that the primary taxpayer identification number may be missing or invalid, would prevent the document from qualifying as a "return" under the case law.<sup>2</sup> However, we agree with your conclusion that the service center can send correspondence to these taxpayers advising them that the Service cannot process the return they filed until they furnish a valid taxpayer identification number.

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<sup>1</sup> In these "Philippines scheme" cases, the problem is an understatement of tax, not an overstatement of the withholding credit. Consequently, the Service's authority under § 6201(a)(3) to assess overstated prepayment credits, including the credit for amounts withheld at the source, without following deficiency procedures, is not relevant.

<sup>2</sup> In some of these situations, there may be information indicating that the taxpayer did not sign the return. For discussion of this factor, see SCA 1998-042, Issue 1.

(b) Math error procedures.

Given that these cases will normally be handled through assessment, following deficiency procedures, you have asked whether the expedited "math error" assessment procedure may be used.

Section 6213 (a) generally bars the assessment or collection of a deficiency until after notice of deficiency has been mailed to the taxpayer and the taxpayer has had an opportunity to contest the deficiency in Tax Court. Section 6213(b)(1), however, provides an exception to these restrictions for an assessment of tax on account of a "mathematical or clerical error." In such a case, notice is sent to the taxpayer, and the taxpayer may request abatement within 60 days. This expedited procedure is only available with respect to the specific "mathematical or clerical errors" defined in § 6213(g)(2).

When taxpayer files a Form 1040NR, Form 1040, Form 1040A, or other document similar to the form described above, it may be clear from the face of the return that the taxpayer, whose address is in the Philippines, does not qualify for a refund of 30-percent withholding on the taxpayer's social security benefits. Depending on the particular document in question, it may be possible that the taxpayer's error falls within one of the listed types in § 6213(g)(2). Generally, however, the error appears to be a substantive one in the nature of an "unallowable item" -- as a legal matter, under the Internal Revenue Code and the U.S.-Philippines income tax treaty, the taxpayer simply does not qualify for the refund -- an error that must be corrected through the deficiency procedures, rather than a "mathematical or clerical error" -- an inconsistent entry, omitted schedule, or other similar mistake -- as to which assessment using the math error procedures is appropriate. In a telephone conversation with personnel at the service center, they indicated that the current volume of these returns is such that there is no need at present to consider whether some of these returns could be processed using math error authority. If that situation changes, we would be happy to reconsider the question. If you have any further questions, please call Sandy Irving or Catherine Prohovsky at (202) 622-4930.

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