



# MANUAL TRANSMITTAL

Department of the Treasury  
Internal Revenue Service

20.1.5

AUGUST 31, 2021

## EFFECTIVE DATE

(08-31-2021)

## PURPOSE

- (1) This transmits revised IRM 20.1.5, Penalty Handbook, Return-Related Penalties.

## MATERIAL CHANGES

- (1) Significant changes to this IRM section are listed in the following table:

Reference	Description of Change
IRM 20.1.5.1	Changed subsection title.
IRM 20.1.5.1.3	TBOR content updated based on guidance from the Division Counsel/Associate Chief Counsel (National Taxpayer Advocate Program) and Branch 3 of the Associate Chief Counsel (Procedure and Administration).
IRM 20.1.5.1.5	Updated acronyms and definitions.
IRM 20.1.5.2.1	Removed language regarding DFO approval requirement.
IRM 20.1.5.2.3	Added reference to IRM 20.1.1 regarding timing of supervisory approval of penalties.
IRM 20.1.5.2.3	Updated to add 6662(b)(9) exception to the written supervisory requirement, per 6751(b)(2)(A) amendment. P.L.116-260.
IRM 20.1.5.2.3.1	Updated section 6751(b) guidance. Added clarifying language for documenting supervisory approval of penalties for penalties imposed by CEAS programs.
IRM 20.1.5.3.1	Updated definitions.
IRM 20.1.5.3.6	Updated because of BBA. Added reference to IRM 4.31.9, Centralized Partnership Audit Regime.
IRM 20.1.5.4	Added clarifying language for supervisory approval of penalties.

Reference	Description of Change
IRM 20.1.5.7.1	Updated to reference the new subsection which addresses special rules relating to reasonable cause for BBA partnerships.
IRM 20.1.5.8.2.1.1	Updated changes to CIC program.
IRM 20.1.5.9	Updated to add language referencing the new subsection which discusses special rules for the calculation of the substantial understatement penalty for BBA partnership adjustments.
IRM 20.1.5.9.2	Updated IRM reference for no-show procedures.
IRM 20.1.5.15.1	Added new subsection to provide policy for new penalty under IRC 6662(b)(9) and 6662(l) for the overstatement of charitable contributions. Enacted by the Consolidated Appropriations Act, 2021 (P.L. 116-260).
IRM 20.1.5.16.2	Added penalty approval language and language referencing the new subsection which discusses special rules for the calculation of the fraud penalty for BBA partnership adjustments.
IRM 20.1.5.16.4	Added language regarding the timely supervisory approval of penalties in collateral estoppel cases.
IRM 20.1.5.17	Added language and reference to new subsection which discusses Section 6662A for BBA partnership adjustments.
IRM 20.1.5.18	Added paragraph regarding reasonable cause for Section 6676 penalty.
IRM 20.1.5.18.4.1	Added clarifying language regarding supervisory approval of penalties per Interim Guidance SBSE-20-0520-0029.

<b>Reference</b>	<b>Description of Change</b>
IRM 20.1.5.18.5	Updated timing requirements to secure supervisory approval of penalties. Clarified language regarding separate case file.
IRM 20.1.5.19 - 20.1.5.19.4	Added Bipartisan Budget Act (BBA) legislation. Added new subsections to provide guidelines for computing penalties with respect to BBA partnership adjustments.

- (2) Editorial changes were made throughout this IRM section. Reviewed and updated grammar, titles, website addresses, legal references and IRM references.

#### **EFFECT ON OTHER DOCUMENTS**

This material supersedes IRM 20.1.5, dated April 22, 2019.

#### **AUDIENCE**

Small Business/Self-Employed (SB/SE), Large Business and International (LB&I), Tax Exempt and Government Entities (TE/GE), Appeals, Wage and Investment (W&I), and other employees who address accuracy-related penalties, fraud penalty, and the erroneous claim for refund or credit penalty.

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20.1.5

Return Related Penalties

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20.1.5.1  
(08-31-2021)  
**Program Scope and Objectives**

- (1) **Purpose:** The purpose of this IRM section is to convey policy as set by the Office of Servicewide Penalties (OSP) as it relates to accuracy-related penalties, the fraud penalty, and the erroneous claim for refund or credit penalty.
- (2) **Audience:** Small Business/Self Employed (SB/SE), Large Business and International (LB&I), Tax Exempt and Government Entities (TE/GE), The IRS Independent Office of Appeals (Appeals), Wage & Investment (W&I), and other employees who address accuracy-related penalties, the fraud penalty, and the erroneous claim for refund or credit penalty.
- (3) **Policy Owner:** The Business Support Office (BSO) is under Operations Support (OS). SB/SE is responsible for overseeing civil penalties, including return-related penalties.
- (4) **Program Owner:** The Office of Servicewide Penalties (OSP) is responsible for civil penalty policy including IRM 20.1.5, Penalty Handbook, Return-Related Penalties.
- (5) **Contact Information:** To recommend changes or make any suggestions to this IRM section, see IRM 1.11.6.6, Providing Feedback About an IRM Section - Outside of Clearance.

20.1.5.1.1  
(08-31-2021)  
**Background**

- (1) The Internal Revenue Service has a responsibility to collect the proper amount of tax revenue in the most efficient manner. Penalties provide the IRS with an important tool to achieve that goal because they enhance voluntary compliance by taxpayers. See IRM 1.2.1.12.1, Policy Statement 20-1 (Formerly P-1-18).

20.1.5.1.2  
(04-22-2019)  
**Authority**

- (1) Authority for the administration of return-related penalties are found in the Internal Revenue Code (IRC), IRC 6662, IRC 6662A, IRC 6663, IRC 6676, and corresponding Treasury Regulations.

20.1.5.1.3  
(08-31-2021)  
**Responsibilities**

- (1) The Director of Business Support, within SBSE Operations Support, is the director responsible for the servicewide civil penalty program.
- (2) Overall responsibility for civil penalty programs is assigned to OSP. OSP is charged with coordinating policy and procedures concerning the administration of civil penalty programs, ensuring consistency with the penalty policy statement, reviewing and analyzing penalty information, and determining appropriate action necessary to promote voluntary compliance.
- (3) Each IRS organization is responsible for establishing an internal process for managing their procedures based upon these servicewide policies and may develop additional guidance or reference materials for their specific functional administrative needs. However, such reference material must receive approval from OSP prior to distribution and must remain consistent with the policies and general procedural requirements set forth in Policy Statement 20-1 (Formerly P-1-18) in IRM 1.2.1.12.1, and other guidance relating to civil penalties.
- (4) All employees should keep the following objectives in mind when handling each penalty case:
  - a. Similar cases and similarly-situated taxpayers should be treated alike.
  - b. Each taxpayer should have the opportunity to have his or her interests heard and considered.

- c. Strive to make a correct decision in the first instance. A wrong decision, even though eventually corrected, has a negative impact on voluntary compliance.
- d. Provide adequate opportunity for incorrect decisions to be corrected.
- e. Treat each case in an impartial and honest way (i.e., approach the job, not from the government's or the taxpayer's perspective, but in the interest of fair and impartial enforcement of the tax laws.
- f. Use each penalty case as an opportunity to educate the taxpayer, help the taxpayer understand his or her legal obligations and rights, assist the taxpayer in understanding his or her appeal rights, and in all cases, observe the taxpayer's procedural rights.
- g. Endeavor to promptly process and resolve each taxpayer's case.
- h. Resolve each penalty case in a manner which promotes voluntary compliance.

- (5) The Taxpayer Bill of Rights (TBOR) lists rights that already existed in the tax code, putting them in simple language and grouping them into 10 fundamental rights. Employees are responsible for being familiar with and acting in accord with taxpayer rights. See IRC 7803(a)(3) , Execution of Duties in Accord with Taxpayer Rights. For additional information about the TBOR, see <https://www.irs.gov/taxpayer-bill-of-rights>.

20.1.5.1.4  
(04-22-2019)

**Program Management  
and Review**

- (1) Every function in the IRS has a role in proper penalty administration. It is essential that each function conducts its operations with an emphasis on promoting voluntary compliance. Appropriate reviews should be conducted to ensure consistency with the penalty policy statement (Policy Statement 20-1) and philosophy.
- (2) To promote the goal of consistency and fairness, OSP will review semi-annually a sample of penalty assessments provided by SB/SE Research. See IRM 20.3.1, Civil Penalty Accuracy Review Process. The report of findings is shared with the Director, Business Support, the CFO, and other leadership as needed. The completed report is uploaded to an enterprise shared folder. Reports may be prepared when a significant issue develops, such as a correction to programming that affects many taxpayers.

20.1.5.1.5  
(08-31-2021)

**Terms/Acronyms**

- (1) The table below list acronyms used in this IRM and their definitions.

Acronym	Definition
ACTC	Additional Child Tax Credit
AIMS	Audit Information Management System
AOTC	American Opportunity Tax Credit
APPEALS	The IRS Independent Office of Appeals
ASED	Assessment Statute Expiration Date
AUR	Automated Underreporter
BBA	Bipartisan Budget Act of 2015

Acronym	Definition
BMF	Business Master File
BSO	Business Support Office
CCP	Centralized Case Processing
CEAS	Correspondence Examination Automation Support
CFOL	Corporate File On Line
CFR	Code of Federal Regulations
CI	Criminal Investigation
CIC	Coordinated Industry Case
CTC	Child Tax Credit
ERCS	Examination Returns Control System
FEA	Fraud Enforcement Advisor
IDRS	Integrated Data Retrieval System
IMF	Individual Master File
IRC	Internal Revenue Code
IU	Imputed Underpayment
LB&I	Large Business & International
LCC	Large Corporate Compliance
MF	Master File
MFJ	Married Filing Jointly
MFT	Master File Tax
NOPPA	Notice of Proposed Partnership Adjustment
OS	Operations Support
OSP	Office of Servicewide Penalties
PRN	Penalty Reference Number
PRC	Penalty Reason Code
RBA	Restitution Based Assessments
RGS	Report Generation Software
SBSE	Small Business Self Employed
SNOD	Statutory Notice of Deficiency
TBOR	Taxpayer Bill of Rights
TCJA	The Tax Cuts and Jobs Act
TEFRA	Tax Equity and Fiscal Responsibility Act
TE/GE	Tax Exempt and Government Entities

Acronym	Definition
W&I	Wage & Investment

20.1.5.2  
(04-22-2019)

**Return-Related Penalties**

- (1) The return-related penalties covered in this IRM include the following:
  - a. IRC 6662, Imposition of Accuracy-Related Penalty on Underpayments
  - b. IRC 6663, Imposition of Fraud Penalty
  - c. IRC 6662A, Imposition of Accuracy-Related Penalty on Understatements with Respect to Reportable Transactions
  - d. IRC 6676, Erroneous Claim for Refund or Credit
  
- (2) IRC 6662 imposes an accuracy-related penalty on any portion of an underpayment attributable to one or more of the following:
  - a. Negligence or disregard of the rules or regulations. See IRM 20.1.5.8, IRC 6662(b)(1), and IRC 6662(c).
  - b. Substantial understatement of income tax. See IRM 20.1.5.9, IRC 6662(b)(2), and IRC 6662(d).
  - c. Substantial valuation misstatement. See IRM 20.1.5.10, IRC 6662(b)(3), and IRC 6662(e).
  - d. Substantial overstatement of pension liability. See IRM 20.1.5.11, IRC 6662(b)(4), and IRC 6662(f).
  - e. Substantial estate or gift tax valuation understatement. See IRM 20.1.5.12, IRC 6662(b)(5), and IRC 6662(g).
  - f. Gross valuation misstatement. See IRM 20.1.5.10.3 and IRC 6662(h).
  - g. Disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of IRC 7701(o)) or failing to meet the requirements of any similar rule of law. See IRC 6662(b)(6) and IRM 20.1.5.13.
  - h. Nondisclosed noneconomic substance transactions. See IRC 6662(i) and IRM 20.1.5.13.1.
  - i. Undisclosed foreign financial asset understatement. See IRC 6662(b)(7), IRC 6662(j), and IRM 20.1.5.14.
  - j. Inconsistent estate basis. See IRM 20.1.5.15, IRC 6662(b)(8), and IRC 6662(k).
  
- (3) IRC 6663 imposes a penalty on any portion of an underpayment attributable to fraud. See IRM 20.1.5.16.1.
  
- (4) IRC 6662A imposes an accuracy-related penalty on a reportable transaction understatement. See IRM 20.1.5.17.
  
- (5) IRC 6676 imposes a penalty for erroneous claim for refund or credit with respect to income tax. See IRM 20.1.5.18.
  
- (6) See IRC 6664, Definitions and Special Rules, for the accuracy-related penalties and IRM 20.1.5.7.1.
  
- (7) **Alternative Positions** - Because a taxpayer can be liable for the accuracy-related penalty on alternative basis, examiners will need to identify each applicable ground for applying the penalty to each adjustment. The most stringent penalty should be developed as the primary position and any other applicable penalty developed as an alternative position. Facts and circum-

stances will determine which penalty is **most stringent**. Development of a primary and alternative position is important in the event that the primary position is not sustained. If more than one penalty is developed, the IRS can utilize the examiner's alternative position to sustain other provisions under IRC 6662.

**Example:** An adjustment warranting a penalty may meet the threshold of a substantial understatement under IRC 6662(b)(2) **and also be attributable** to the taxpayer's clearly negligent actions under IRC 6662(b)(1). When both penalties apply, each penalty should be developed and approved by the immediate supervisor of the employee making the initial determination. The Examiner should assert the penalty most strongly supported by the facts and circumstances as the primary position, and write up the other penalty as the alternative.

(8) **Developing alternative positions** is important in the event that such penalized adjustments are challenged and later reduced to a level where the most stringent penalty no longer applies, then the IRS can utilize the examiner's alternative position to sustain other penalty provisions under the Code.

20.1.5.2.1  
(08-31-2021)  
**Large Business and  
International (LB&I)**

(1) LB&I examiners must consider the accuracy-related penalty during their examinations. Examiners are required to consider and then, if appropriate, develop the accuracy-related penalty in all cases in which there is an underpayment of tax attributable to a listed transaction.

(2) If an underpayment of tax is attributable to a taxpayer's participation in a listed transaction, the examiner must develop the accuracy-related penalty issues and prepare a written report supporting the recommendation to impose or not to impose the penalty.

(3) When an examiner identifies a new potentially abusive tax shelter transaction or promoter information, the examiner must contact LB&I field counsel as well as the Office of Tax Shelter Analysis (OTSA).

20.1.5.2.2  
(04-22-2019)  
**Small Business/Self-  
Employed Examination  
(SB/SE)**

(1) SB/SE examiners should follow procedures outlined in IRM 20.1.5.2.3 regarding supervisory approval for imposing penalties in a tax shelter case involving a listed transaction.

(2) Examiners should send promoter information to the Lead Development Center (LDC) and also involve the employee designated by their business unit responsible for coordinating and assisting in the identification of abusive tax shelters. See IRM 4.32.2, Abusive Transactions, for additional guidance.

20.1.5.2.3  
(08-31-2021)  
**Supervisory Approval of  
Penalties - IRC 6751  
Procedural  
Requirements**

(1) IRC 6751(a), Computation of Penalty Included in Notice, requires that each penalty notice include the name of the penalty, the Code section under which the penalty is imposed, and a computation of the penalty.

(2) IRC 6751(b)(1), Approval of Assessment, provides in general that no penalty under the IRC shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate. See IRM 20.1.1.2.3, Approval Prerequisite to Penalty Assessments.

- (3) The written approval should be obtained in a timely manner. See IRM 20.1.1.2.3.1, Timing of Supervisory Approval, for policy related to the timing of supervisory approval.
- (4) Exceptions to these procedural requirements are found in IRC 6751(b)(2) that include the following:
  - a. Any addition to tax under IRC 6651, IRC 6654, IRC 6655, or IRC 6662(b)(9); or
  - b. Any other penalty automatically calculated through electronic means. See IRM 20.1.5.2.3.1 for further guidance for AUR and campus exam correspondence cases.

**Note:** Although supervisory approval is not required under section 6751(b) for penalties asserted under section 6651(f), the IRS requires such approval as a matter of policy. See IRM 20.1.2.3.7.5.1, FFTF Penalty Assessment-Procedural Requirements.

- (5) Any function not listed in IRM 20.1.5.2.3.1 that has examiners asserting penalties, must obtain written supervisory approval as required by IRC 6751(b). This written approval must be timely, and retained in the case file.
- (6) Any penalties automatically calculated through electronic means are excluded from IRC 6751(b)(1) requirement.
  - a. AUR (Automated Underreporter) and CEAS (Correspondence Examination Automation Support) cases in which the Substantial Understatement Penalty is systemically asserted, will fall within the exception for penalties automatically calculated through electronic means if the taxpayer does not submit any response to the 30-day letter that proposes the penalty.
  - b. However, if a taxpayer submits a response, written or otherwise, that challenges the penalty or the liability to which the penalty relates, written supervisory approval under IRC 6751(b)(1), is required before any written communication of penalties that offers the taxpayer an opportunity to sign an agreement, or consent to assessment or proposal of the penalty. See IRM 20.1.1.2.3.1, Timing of Supervisory Approval. The exception for penalties automatically calculated through electronic means no longer applies once a Service employee makes an independent determination to pursue a penalty or to pursue adjustments to tax for which a penalty is attributable.
- (7) The IRS also requires supervisory approval of the non-assertion of penalties when there is a substantial understatement of tax under IRC 6662(d), Substantial Understatement of Income Tax.

20.1.5.2.3.1  
(08-31-2021)  
**Documenting  
Supervisory Approval of  
Penalties**

- (1) The employee initially proposing the penalty should indicate the name of the penalty, applicable IRC section, and the amount of the penalty on the examination report. The penalty computation and approval of the penalty must be documented in the case file.
- (2) Written supervisory approval must cover all tax years and penalties, including alternative penalties.

- (3) Supervisory approval may be documented in the form of an e-mail, memo to file, or on a penalty approval form (e.g., Lead Sheet 300, Civil Penalty Approval Form, SAIN 011 Lead Sheet, Form 4700, signed comment on Form 5464, Form 8278, Form 5701).
- (4) On correspondence examination automation support (CEAS) cases, the supervisor will indicate their approval by leaving a CEAS non-action note specifically stating which penalty is approved. In a deficiency case, the CEAS non-action note must be input prior to issuing any written communication of penalties that offers the taxpayer an opportunity to sign an agreement, or consent to assessment or proposal of the penalty. See IRM 20.1.1.2.3, Timing of Supervisory Approval, for further information.

20.1.5.2.4  
(08-31-2021)  
**Penalty Relief Related to  
Incorrect or Delayed  
Forms 1095-A**

- (1) IRS Notice 2015-30 provides penalty relief for the 2014 taxable year for the accuracy-related penalty under IRC 6662 for taxpayers who received a Form 1095-A, Health Insurance Marketplace Statement, that was delayed or that the taxpayer believes to be incorrect and who timely filed their 2014 income tax return, including extensions.
- (2) The Notice relief provisions do not apply to 2014 income tax returns that are late-filed.
- (3) Generally, the IRS will not impose the accuracy-related penalty under IRC 6662 for the 2014 taxable year on any portion of an underpayment resulting from the receipt of an incorrect or delayed Form 1095-A.
- (4) To be eligible for penalty relief, taxpayers who were not enrolled in a qualifying plan during 2014, erroneously received a Form 1095-A, and used it to claim a premium tax credit must amend their 2014 income tax return by April 15, 2016 to reflect that they were not eligible to claim the premium tax credit and must pay any additional tax liability due.
- (5) If an IRC 6662 penalty was imposed for the 2014 taxable year on examination on an underpayment resulting from Form 1095-A, the taxpayer was enrolled in a qualifying plan during 2014, and the taxpayer notifies the IRS, in accordance with Notice 2015-30 that the Form 1095-A was incorrect or delayed, the IRC 6662 penalty will be waived or abated on the portion of the underpayment resulting from Form 1095-A. If the taxpayer was not enrolled in a qualifying plan during 2014, the taxpayer must also appropriately amend his or her 2014 income tax return by April 15, 2016 and pay any additional tax due before the IRC 6662 penalty will be waived or abated on the portion of the underpayment resulting from an erroneous Form 1095-A.

20.1.5.3  
(12-13-2016)  
**Definitions and Related  
Topics**

- (1) This section covers topics that enhance the understanding and application of return-related penalties.

20.1.5.3.1  
(08-31-2021)  
**Definitions**

- (1) **Amount of Tax Imposed:** This is the amount of tax imposed on the taxpayer under subtitle A for the taxable year, determined without regard to certain withheld taxes, payments of tax or estimated tax, any credit resulting from a termination or jeopardy assessment, and any tax the taxpayer is not required to assess on the return. Refer to 26 CFR 1.6664-2(b) for a detailed definition.

- (2) **Centralized Partnership Audit Regime:** Examination subject to the Bipartisan Budget Act of 2015 (BBA).
- (3) **Economic Substance Doctrine:** The economic substance doctrine is defined as the common law doctrine under which income tax benefits with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose. Some courts have required a lack of economic substance or business purpose, while others have required the absence of both. Section 1409 of the Health Care and Education Reconciliation Act of 2010 added IRC 7701(o), Clarification of Economic Substance Doctrine to the Code to provide clarification of the economic substance doctrine. That section applies to transactions entered into after March 30, 2010. IRC 7701(o) (1) provides that a transaction is treated as having economic substance only if the transaction changes the taxpayer's economic position in a meaningful way apart from federal income tax effects and the taxpayer has a substantial purpose for entering into the transaction apart from federal income tax effects. See IRC 7701(o) for additional rules and applicability.
- (4) **Listed Transaction:** A listed transaction is a reportable transaction, which is the same as, or substantially similar to, a transaction specifically identified by the IRS as a tax avoidance transaction for purposes of IRC 6011, General Requirement of Return, Statement, or List. See IRC 6707A(c)(2), Listed Transactions, and 26 CFR 1.6011-4(b)(2).
- (5) **Partnership Adjustment:** Any adjustment to a partnership-related item as defined in IRC 6241.
- (6) **Push-out Election:** A partnership making an election under the alternative to the payment of the imputed underpayment under IRC 6226 is not liable for the imputed underpayment to which the election applies. The election must be made within 45 days of the notice of final partnership adjustment.
- (7) **Qualified Amended Return:** 26 CFR 1.6664-2(c)(3) provides that a qualified amended return is an amended return, or a timely request for administrative adjustment under IRC 6227, Administrative Adjustment Requests, filed after the due date of the return (determined with regard to extensions), and before the earliest of :
  - a. The receipt of an audit notification letter;
  - b. Contact concerning an activity described in IRC 6700, *Promoting Abusive Tax Shelters, Etc.*;
  - c. The date a pass-through entity is first contacted by the IRS;
  - d. The date the IRS serves a John Doe summons relating to the tax liability of a person, group, or class that includes that taxpayer or pass-through entity in which the taxpayer may have an interest;
  - e. The date on which the IRS announces a settlement initiative to compromise or waive penalties with respect to a listed transaction; or
  - f. With respect to an undisclosed listed transaction, contact concerning activity described in IRC 6707(a), Failure to Furnish Information Regarding Reportable Transactions, or contact concerning a list described in IRC 6112, Material Advisors of Reportable Transactions Must Keep Lists of Advisees, Etc.

- (8) **Reasonable Basis:** Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. See 26 CFR 1.6662-3(b)(3).
- (9) **Rebate:** A rebate is the amount of an abatement, credit, refund, or other repayment made on the basis that the tax imposed was less than the excess of the sum of the following:
- The amount shown as a tax by the taxpayer on the return, plus
  - Amounts not shown previously assessed (or collected without assessment) over rebates previously made.
- (10) **Reportable Transaction:** Any transaction with respect to which information is required to be included with a return or statement because, as determined under regulations prescribed under IRC 6011, such transaction is of a type that the IRS determines as having a potential for tax avoidance or evasion. See IRC 6707A(c)(1), *Reportable Transaction*, and 26 CFR 1.6011-4(b)(1).
- (11) **Reportable Transaction Understatement:** The reportable transaction understatement is the sum of the following:
- The increase in taxable income that results from a difference between the proper tax treatment of the item related to the transaction and the taxpayer's treatment of the item multiplied by the highest tax rate imposed by IRC 1, for individuals or IRC 11 for corporations.
  - The decrease in the aggregate amount of credits which results from the difference between the credits the taxpayer claimed and the proper amount. See IRM 20.1.5.17.2 for a calculation example.
- (12) **Reviewed Year:** The partnership taxable year to which a partnership adjustment relates.
- (13) **Reviewed Year Partner:** Any person who held an interest in a partnership at any time during the reviewed year.
- (14) **Underpayment:** Refer to 26 CFR 1.6664-2(a) for a detailed description. An underpayment is defined as the amount by which any tax imposed exceeds the excess of the following:
- The sum of the amount shown as the tax by the taxpayer on his return, plus
  - Amounts not so shown that were previously assessed (or collected without assessment), over
  - The amount of rebates made.

**Note:** In calculating the amount of the underpayment, refundable credits are included in determining the amount of income tax imposed and the amount shown by the taxpayer on their return. The PATH Act which was passed December 18, 2015 clarified that tax can be reduced below zero. The amount shown as the tax by the taxpayer on their return under 26 CFR 1.6664-2(c) of the underpayment definition, is reduced by overstated: 1) tax withheld from wages, 2) tax withheld at source on a nonresident alien or foreign corporation, 3) estimated tax payments; or 4) other payments the taxpayer claims as having been made before the return was filed.

- When the IRS freezes the refund or credit of a claimed overpayment, the amount by which the allowable prepayment credits exceed the tax shown on the return is an amount collected without assessment. If the IRS only

freezes a portion of the claimed overpayment, the amount collected without assessment is reduced by the amount allowed as a refund or credit. See Exhibit 20.1.5-8, Calculation of an Underpayment Involving Frozen Refunds, for an example of this type of calculation.

20.1.5.3.2  
(04-22-2019)  
**Common Features of Accuracy-Related and Civil Fraud Penalties**

- (1) The accuracy-related and civil fraud penalties apply only if a return is filed.
- (2) The accuracy-related and civil fraud penalties generally **do not** apply in the case of a return prepared by the IRS under IRC 6020(b), Returns Prepared for or Executed by Secretary. However, the accuracy-related and fraud penalties **can be asserted** on a secured delinquent return such as an original return obtained after the taxpayer is contacted by the IRS.

**Reminder:** Examiners should review available IRS CFOL information when making penalty determinations to establish payment patterns and any history of non-compliance.

- (3) The accuracy-related and civil fraud penalty issues are developed separately from the tax law issues that gave rise to the tax understatement. Penalty issues require review and supervisory approval prior to being asserted.

**Note:** Accuracy-related penalties systemically assessed under the AUR and CEAS programs, require supervisory approval if the taxpayer submits a response. See IRM 20.1.1.2.3.2, and IRM 20.1.5.2.3.1.

- (4) Generally, requests for penalty abatements should be addressed by the office that initially conducted the examination. See IRM 20.1.5.4.2 and IRM 20.1.5.7. Also see IRM 20.1.1.3.5.2, Taxpayer Entitled to Relief.
- (5) Claims for refund on assessed accuracy-related and civil fraud penalties are handled like other claims.
- (6) **Uniform Definition of Underpayment:** IRC 6664(a), Underpayment, provides a common definition of underpayment. See IRM 20.1.5.3.1 for underpayment calculation. The accuracy-related and civil fraud penalties are calculated only on the underpayment (or portion of the underpayment) of tax attributable to the misconduct or fraud.
- (7) **Coordination of Accuracy-Related and Civil Fraud Penalties:** The accuracy-related and civil fraud penalties cannot be asserted on the same portion of the same underpayment, except as an alternative penalty position. However, the accuracy-related penalty and the civil fraud penalty may be asserted on the same return when civil fraud applies to one portion of the underpayment and the accuracy-related penalty applies to another portion of the underpayment.
- (8) **Coordination of the Accuracy-Related Penalty Attributable to a Reportable Transaction Understatement and the Civil Fraud Penalty:** The accuracy-related penalty attributable to a reportable transaction understatement and the civil fraud penalty cannot be asserted on the same portion of the same understatement (a reportable transaction understatement is treated as an underpayment for purposes of determining the fraud penalty). However, the accuracy-related penalty attributable to a reportable transaction understatement and the civil fraud penalty may be asserted on the same return when civil

fraud applies to one portion of the underpayment and the accuracy-related penalty attributable to a reportable transaction understatement applies to another portion. See IRC 6662A(e).

- (9) **Interest:** Under IRC 6601(e)(2)(B), Interest on Penalties, Additional Amounts, or Additions to the Tax, interest on civil fraud and accuracy-related penalties is imposed from the due date of the return, including extensions, until the module is fully paid. Per IRC 6601(e)(3), Payments Made Within Specified Period After Notice and Demand, if the payment is received on or before 21 calendar days after notice and demand (10 business days if the amount for which the notice and demand equals or exceeds \$100,000), interest stops on the amount paid as of the date of the notice and demand. See IRM 20.2.7, Interest, Abatement and Suspension of Debit Interest, for other periods of interest suspension.
- (10) **Deficiency Procedures Apply:** Follow the guidelines for Examination 30-day letter procedures and statutory notice of deficiency procedures for the accuracy-related and civil fraud penalties because those penalties are subject to deficiency procedures. In addition, erroneous claim penalties (see IRM 20.1.5.18) under IRC 6676 will follow deficiency procedure guidelines when an excessive amount of a refund is attributable to a disallowed refundable credit. See IRM 20.1.5.18.
- (11) **Coordination of Accuracy-Related and Civil Fraud Penalties with Penalties Under IRC 6676, Erroneous Claim for Refund or Credit:** Accuracy-related and civil fraud penalties apply to an underpayment. For downward adjustments on original returns that are not subject to an accuracy-related or fraud penalty because of the lack of an underpayment, consideration should be given to the application of IRC 6676. The IRC 6676 penalty should be considered on the excessive amount that is not subject to IRC 6662 or IRC 6663. Under these circumstances, the penalty is subject to deficiency procedures because the penalty is dependent upon the existence of a deficiency. See IRM 20.1.5.18.

20.1.5.3.3  
(04-22-2019)  
**Allocation of an Underpayment**

- (1) An allocation is necessary when both the accuracy-related and the civil fraud penalties apply. For example, when there are three return adjustments, and one penalty applies to just one of the three, apply the penalty rate times the amount of that adjustment's underpayment. This is the amount of the penalty.
- (2) In computing the portions of an underpayment subject to penalties imposed under IRC 6662 and IRC 6663, adjustments to a return are considered made in the order as follows:
  - a. Those for which no penalties are imposed.
  - b. Those for which a penalty has been imposed at a 20 percent rate (e.g., a penalty for negligence or disregard of rules or regulations, substantial understatement of income tax or substantial valuation misstatement, under IRC 6662(b)(1) through IRC 6662(b)(3), respectively).
  - c. Those for which a penalty is imposed at a 40 percent rate (e.g., a penalty for a gross valuation misstatement under IRC 6662(h)).
  - d. Those for which a penalty has been imposed at a 75 percent rate (e.g., a penalty for fraud under IRC 6663).

See 26 CFR 1.6664-3 for additional guidance and Exhibit 20.1.5-2, Calculation of the Accuracy-Related Penalty Attributable to a Substantial Understatement., for three different types of adjustment calculations.

- (3) See IRM 20.1.5.17.3 for an example of a calculation involving IRC 6662(d), IRC 6663, and IRC 6662A.
- (4) Any income tax withholding, estimated tax payments, or other payment made before a return was filed that was not claimed on the return or previously allowed as a credit against the tax liability for the taxable year is allocated as follows:
  - a. If the unclaimed prepayment credit is allocable to a particular adjustment (e.g., withholding on unreported Form W-2, *Wage and Tax Statement* income), the credit is used to reduce the amount of the underpayment resulting from the adjustment.
  - b. If the unclaimed prepayment credit is not allocable to a particular adjustment, the credit is applied in accordance with the ordering rules set forth in 26 CFR 1.6664-3(c).

See 26 CFR 1.6664-3(d) for examples illustrating the manner in which unclaimed prepayment credits are to be allocated.

20.1.5.3.3.1  
(08-31-2021)  
**“No Stacking” Provision**

- (1) There is “no stacking” of accuracy-related penalty components. The maximum penalty that may be imposed on a portion of an underpayment is 20 percent (or 40 percent in the case of a gross valuation misstatement, nondisclosed noneconomic substance transaction, or undisclosed foreign financial asset understatement), even if such portion is attributable to more than one type of misconduct (e.g., an underpayment attributable to both negligence and a substantial understatement).
- (2) Only one penalty rate applies to any portion of an underpayment. When two penalties could apply, the penalty at the higher rate is asserted. If two penalties at the same rate would apply, assert the penalty that is more comprehensively applicable. In unagreed cases, include the other penalty in the report as an alternative penalty position.
- (3) The “no stacking” provision in 26 CFR 1.6662-2(c) is illustrated as follows:
  - a. If a portion of the underpayment of tax shown on a return is attributable to both negligence and a substantial understatement, the accuracy-related penalty would apply only once at the 20 percent rate to this portion of the underpayment. The examiner should assert the penalty that is most strongly supported by the facts and circumstances and write up the other as an alternative penalty position.
  - b. The penalty is applied at the 40 percent rate on any portion of the underpayment attributable to a gross valuation misstatement. Any penalty at the 20 percent rate that could have applied to this portion is not asserted except as an alternative penalty position.
  - c. A penalty is applied at the 75 percent rate on any portion of the underpayment attributable to civil fraud. Any penalty that could have applied to this portion at the 20 or 40 percent rate is not asserted except as an alternative penalty position.

20.1.5.3.4  
(12-13-2016)  
**Carrybacks and Carryovers**

- (1) The amount of an underpayment subject to IRC 6662 or IRC 6663 will not be reduced by any carryback of a loss, deduction, or credit to that year.

**Example:** A tax year (TY) 2013 examination adjustment results in an underpayment of \$3,000, which is subject to the accuracy-related penalty attributable to negligence. The amount of the negligence penalty imposed for TY 2013 is \$600 (20 percent x \$3,000). A \$12,000 net operating loss (NOL) carryback from TY 2014 to TY 2013 offsets the \$3,000 underpayment for income tax purposes, but the \$3,000 underpayment is still subject to the penalty because the NOL is not taken into account in determining the underpayment for TY 2013. Consequently the amount of the penalty for TY 2013 remains as \$600.

- (2) If an underpayment in a loss year is subject to IRC 6662 or IRC 6663 and that loss is carried back to an earlier year or carried forward to a later year, any underpayment resulting from the disallowance of the loss in the earlier or later year will also be subject to IRC 6662 or IRC 6663. See 26 CFR 1.6662-3(d), 26 CFR 1.6662-4(c) and 26 CFR 1.6662-5(c).

**Example:** The taxpayer filed a TY 2013 return with an NOL of \$45,000. The taxpayer carried forward \$20,000 of the NOL to TY 2014. An examination of the TY 2013 return results in an adjustment of \$60,000 due to the negligent omission of income. The \$45,000 NOL is disallowed in full and there is an underpayment of \$3,000 for TY 2013. The \$20,000 amount carried over from TY 2013 to TY 2014 is disallowed. This produces a TY 2014 underpayment of \$2,000. Because this is the result on an adjustment for which negligence applied in TY 2013, the penalty also applies to the TY 2014 underpayment.

**Note:** If the NOL disallowance for TY 2013 did not result in an underpayment, but did create an underpayment for TY 2014 (due to the disallowed carryover from TY 2013), then the accuracy-related penalty would apply to the underpayment in TY 2014 only.

- (3) When the penalty assertion requires a dollar threshold (e.g., \$5,000 for substantial understatements and valuation misstatements), this threshold must be met for each year in which the penalty will be asserted (including a carryback or carryover year).
- (4) For special rules regarding carrybacks and carryovers in the area of transfer pricing, see 26 CFR 1.6662-6(e).
- (5) In the case of carrybacks and carryovers, adequate disclosure is made on the return for the taxable year in which the carryback or carryover originates. See IRM 20.1.5.8.2.1 for more information relating to adequate disclosure.

20.1.5.3.5  
(04-22-2019)  
**Two and Ten Year Bans on Claiming the Earned Income Tax Credit (EITC), Child Tax Credit (CTC), Additional Child Tax Credit (ACTC), and American Opportunity Tax Credit (AOTC)**

- (1) The 2-year ban under IRC 32(k)(1)(B)(ii) applies when it is determined that a taxpayer recklessly or intentionally disregarded the EITC rules when claiming the EITC. For taxable years beginning after December 31, 2015, the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act) expanded the 2-year ban rule to the CTC/ACTC under IRC 24(g)(1)(B)(ii), and the AOTC under IRC 25A(b)(4)(A)(ii)(II).
- (2) The 10-year ban under IRC 32(k)(1)(B)(i) applies when it is determined that a taxpayer fraudulently claimed the EITC. For taxable years beginning after December 31, 2015, the PATH Act expanded the 10-year ban rule to apply to the CTC/ACTC under IRC 24(g)(1)(B)(i), and AOTC under IRC

25A(b)(4)(A)(ii)(I). The 2 or 10 year ban do not apply to the Lifetime Learning Credit under IRC 25A(c), or the Tuition and Fees deduction under IRC 222.

- (3) The 2 or 10 year ban can be asserted along with the accuracy-related penalty or any other penalty imposed under present law. The law does not require that an accuracy-related penalty be asserted in order to impose the EITC, CTC/ACTC or AOTC 2 or 10 year ban.

**Note:** IRC 6751(b)(1) does not apply to the 2 or 10 year ban. However, managerial approval is required for all 2 or 10 year ban cases as a matter of policy.

See IRM 4.19.14.7.1, 2/10 Year Ban-Correspondence Guidelines for Examination Technicians (CET).

- (4) The 10-year ban for fraudulently claiming the EITC, CTC/ACTC, or AOTC, essentially follows criteria for assertion of civil fraud under IRC 6663. See IRM 20.1.5.16.2.

**Note:** The 10-year ban can be asserted when it is applicable, even if the fraud penalty is not (or cannot be) applied.

- (5) The assertion of the 10-year ban is independent of whether the taxpayer's reporting results in an "underpayment," per IRC 6664, on which the civil fraud penalty is based. The 10-year ban falls under a different Internal Revenue Code section and should, nonetheless, be considered for assertion.
- (6) For information on EITC procedures see IRM 4.19.14, Liability Determination, EITC Revenue Protection Strategy.

#### 20.1.5.3.6 (08-31-2021)

#### Notice of Inconsistent Treatment

- (1) A partner, S corporation, shareholder, beneficiary of an estate or trust, owner of a foreign trust, or residual interest holder in a real estate mortgage investment conduit (REMIC) generally must report items consistent with the way they were reported on Schedule K-1, Schedule Q, or a foreign trust statement.
- (2) Form 8082, *Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)*, is used to notify the IRS of any inconsistency between the tax treatment of an item by an impacted person and the way the pass-through entity treated and reported such item.
- (3) Form 8082 is also used to notify the IRS if an impacted person did not receive a Schedule K-1, Schedule Q, or foreign trust statement.
- (4) If the Form 8082 is not filed as required, the taxpayer may be subject to the accuracy-related penalty under IRC 6662 or the fraud penalty under IRC 6663.
- (5) See IRC 6227 (prior to the enactment of BBA) and IRM 4.31.4, TEFRA Administrative Adjustment Request (AAR), for additional information. Also see IRM 4.31.9, Centralized Partnership Audit Regime (BBA) Field Examination Procedures.

#### 20.1.5.4 (08-31-2021)

#### Examination Penalty Assertion

- (1) The examiner is responsible for the assertion of return-related penalties including the accuracy-related penalties, the fraud penalty, and the erroneous claim for refund or credit penalty.
- (2) The applicable return-related penalty is to be addressed in all examinations and the workpapers should be prepared under the guidelines as follows:

- a. All examiners are required to document the procedures used, information obtained, and conclusions reached in deciding to recommend or not recommend applicable penalties during examinations.
  - b. For examination adjustments that clearly do not involve penalties (for example, an adjustment allowing an additional exemption), a brief statement to that effect is sufficient. However, standard statements such as “penalty deemed not to be applicable” are not sufficient when adjustments proposed by an examiner result in an underpayment of tax or denial of a claim for refund or credit.
  - c. An alternative penalty position should be documented in the workpapers and report when applicable. For additional guidance regarding alternative positions, see IRM 4.10.8.12.5, Alternative Positions.
  - d. The IRS requires supervisory approval on the non-assertion of penalties when there is a substantial understatement of tax under IRC 6662(d). See IRM 20.1.5.9 for substantial understatement criteria.
  - e. Penalties subject to IRC 6751(b)(1), require written supervisory approval. Approval must be obtained prior to issuing any written communication of penalties that offers the taxpayer an opportunity to sign an agreement, or consent to assessment or proposal of the penalty. See IRM 20.1.1.2.3, Timing of Supervisory Approval.
  - f. Documenting supervisory approval of penalties is discussed in IRM 20.1.5.2.3.1.
  - g. When a penalty appears warranted but it is not asserted, the applicable exceptions to the penalty will be documented in the workpapers or penalty lead sheets.
  - h. Taxpayer claims for penalty relief under IRC 6664 must be evaluated. If a taxpayer cannot meet the standards for penalty relief for a penalty in question, the penalty should be applied.
  - i. With managerial approval, counsel may be contacted to assist the examiner with penalty development when evaluating a taxpayer’s reasonable basis, reasonable cause, and substantial authority defenses.
- (3) Form 3198, Special Handling Notice for Examination Case Processing, or Form 3198-A, TE/GE Special Handling Notice, should be attached to each penalty case except for campus RGS/CEAS cases. The examiner will identify the applicable IRC section on the form for the Centralized Case Processing (CCP) function.
  - (4) Examiners will identify the adjustments related to each penalty in the report, and they will identify each penalty separately by name, IRC section, and penalty computation.
  - (5) In proposing the penalty to the taxpayer or taxpayer’s representative, the examiner will do the following:
    - a. Fully explain the proposed penalty.
    - b. Document the reasons why the penalty assertion is appropriate.
    - c. Consider and document any possible exceptions to the penalty provided by the taxpayer or the taxpayer’s representative, whether or not they are accepted.

**Note:** The level of taxpayer cooperation is not grounds for asserting or not asserting a penalty.

- (6) When more than one component of the accuracy-related penalty may apply to the same portion of an underpayment (e.g., negligence and substantial understatement), assert the penalties as follows:
  - a. On agreed cases, assert the penalty with the strongest position in the report.
  - b. On unagreed cases, assert the penalty with the strongest position in the report and list any other applicable penalties as alternative positions.

**Reminder:** The alternative penalty position(s) is included in the examination 30-day letter and in the statutory notice of deficiency. Written supervisory approval is required for not only the primary penalty, but alternative penalties as well.

20.1.5.4.1  
(08-31-2021)  
**IMF Automated  
Underreporter Penalty  
Assertion**

- (1) The Automated Underreporter (AUR) program matches information returns against individual income tax returns to verify that income is reported and deductions taken correctly.
- (2) AUR computer-generated notices are for Individual Master File (IMF). If the accuracy-related penalty is applicable, the AUR system generates the appropriate penalty paragraph for CP 2501, Initial Inquiry Letter, or the CP 2000, Notice of Proposed Adjustment. In the absence of a taxpayer response to the letter or notice, the penalty determination will be made on the basis of return information and the significance of the amounts omitted.
- (3) On AUR cases involving certain taxpayer contacts, the assertion of the accuracy-related penalty requires written supervisory approval. See IRM 20.1.5.2.3.
- (4) Notices and reports will fully identify the names, IRC sections, and the computation of the penalty amounts being asserted.
- (5) All penalty determinations involving a reasonable cause exception will be documented in the workpapers. This will be done by identification on the AUR system and will remain with the case file.
- (6) In unagreed cases, the IRS will provide the taxpayer or representative with a complete explanation of the penalty.
- (7) See IRM 4.19.3.18.5, Accuracy-Related Penalty Due to Substantial Understatement of Tax, for penalties related to AUR cases.

20.1.5.4.2  
(08-31-2021)  
**Penalty Assessments  
and Abatements**

- (1) The examiner will compute the accuracy-related penalty for CCP.
- (2) The amount of the IRC 6662 penalty is 20 percent of the portion of the underpayment resulting from the misconduct. The penalty rate increases to 40 percent in certain circumstances involving gross valuation misstatements, non-disclosed noneconomic substance transactions, and undisclosed foreign financial asset understatements.
- (3) The amount of the IRC 6663 penalty is 75 percent of the underpayment due to fraud. See IRM 20.1.5.16.5.

- (4) The amount of the IRC 6662A penalty is 20 percent of the reportable transaction understatement. The penalty rate increases to 30 percent of the reportable transaction understatement where the transaction was **not** properly disclosed. See IRM 20.1.5.17.4.
- (5) The amount of the IRC 6676 penalty is 20 percent of the “excessive amount.” See IRM 20.1.5.18.
- (6) Stacking of IRC 6662, IRC 6663, IRC 6662A, and IRC 6676 penalties is not permitted. The maximum amount of the IRC 6662 penalty imposed on a portion of an underpayment of tax is 20 percent (or 40 percent in certain circumstances) of that portion of the underpayment, even if that portion of the underpayment is attributable to more than one type of misconduct under IRC 6662.

**Reminder:** Although “stacking” of penalties is not permitted, other penalties should be developed and documented as alternative positions when appropriate. See IRM 20.1.5.4(c).

- (7) For assessment of accuracy-related penalties, erroneous claim for credits penalties, and fraud penalties, compute the penalty amount and enter it and the penalty reference number (PRN) on Form 5344, Examination Closing Record, Form 5403, Appeals Closing Record, or Form 5599, TE/GE Examined Closing Record.

**Note:** The penalty amount and PRN will automatically flow to the Form 5344 on cases worked through RGS.

- (8) Using the appropriate closing record, enter the **PRN listed below** to assess the following components of the accuracy-related penalty:

Penalty	Description	PRN
IRC 6662(b)(1) and IRC 6662(c)	Negligence or Disregard of the Rules and Regulations	786
IRC 6662(b)(2) and IRC 6662(d)	Substantial Understatement	787
IRC 6662(b)(3) and IRC 6662(e)	Substantial Valuation Misstatement	788
IRC 6662(b)(4) and IRC 6662(f)	Substantial Overstatement of Pension Liabilities	789
IRC 6662(b)(5) and IRC 6662(g)	Substantial Estate or Gift Tax Valuation Understatement	790
IRC 6662(b)(6)	Noneconomic Substance Transaction	780

Penalty	Description	PRN
IRC 6662(h)	Increase in Penalty in Case of Gross Valuation Misstatement	792
IRC 6662(i)	Increase in Penalty in Case of Nondisclosed Noneconomic Substance Transactions	781
IRC 6662(b)(7) and IRC 6662(j)(3)	Increase in Penalty for Undisclosed Foreign Financial Asset Understatements	683
IRC 6676	Erroneous Claim for Refund or Credit	687 (Deficiency procedures) 565 (Non-deficiency procedures)

**Note:** Penalties under PRNs 786 through 792 were all previously housed under PRN 680. Now, when the penalty is for substantial understatement and negligence is a secondary consideration, PRN 680 will still be used.

- (9) Use **PRN 681** and the computed penalty amount to assess a reportable transaction understatement penalty under IRC 6662A. See IRM 20.1.5.17.4.
- (10) TC 240 will automatically post to the Master File (MF) account that relates to the assessment of an accuracy-related penalty.
- (11) MF will systemically compute interest on an accuracy-related penalty from the due date or extended due date of the return (whichever is later) to the earlier of the following:
  - a. The date of payment,
  - b. Waiver date plus 30 days, or
  - c. The notice and demand date, which is usually the 23C date, if the tax is paid within the appropriate time period after notice and demand.
- (12) When abating an assessed IRC 6662 penalty, use the PRN corresponding to the original assessment. To abate an assessed IRC 6662A penalty, use PRN 681. TC 241 will automatically post to the MF account that relates to an abatement of an accuracy-related penalty. A penalty abatement amount can be in part or the full assessed penalty amount. A penalty reason code (PRC) must always be entered for penalty abatements. See IRM 20.1.1.5.1, Master File Penalty Reason Codes.

**Note:** Use a negative dollar amount on Form 8278 with the appropriate PRN to abate a penalty.

- (13) IRC 6676, Erroneous Claim for Refund or Credit, is assessed using Form 3870, *Request for Adjustment*, for married filing joint (MFJ) returns or Form

8278 for all other filing statuses including corporate returns. Use PRN 687 for MFJ returns only. Use PRN 565 for all other filing statuses. For additional guidance regarding IRC 6676 see IRM 20.1.5.18.

20.1.5.5  
(08-31-2021)  
**Post-Assessment  
Abatement  
Consideration of  
Accuracy-Related  
Penalties**

- (1) If a taxpayer is afforded an opportunity to provide information to explain why the penalty should not be asserted but **does not**, the statutory notice of deficiency showing additional tax and penalties should be issued.
- (2) If the notice defaults without taxpayer contact, the tax, penalties, and interest are assessed.
- (3) If a taxpayer receives notice and demand for tax and penalty payment and then makes his or her first response to the IRS requesting abatement of the accuracy-related penalty, the penalty abatement request will be considered based on the evidence provided.
- (4) The function responsible for the penalty assessment should decide whether the penalty should be abated.
- (5) If the evidence is not sufficient to support a reasonable cause claim for the penalty abatement, the taxpayer should be issued the appropriate letter. For example, the campus would issue Letter 854C that should include paragraphs E, or F which are specific to accuracy-related penalties. The appropriate letter should also indicate that the abatement request is denied and that the remaining recourse is to pay the tax, penalties, and interest and file a claim for refund on Form 843, *Claim for Refund and Request for Abatement*. See IRM 21.5.3.4, General Claims Procedures.

**Note:** Appeals procedures language in paragraph Y should not be included when E or F paragraphs is selected on Letter 854-C.

- (6) Post-assessment consideration of IRC 6662 and IRC 6662A accuracy-related penalty abatement requests are *not* forwarded to Appeals.

20.1.5.6  
(01-24-2012)  
**Statute of Limitations**

- (1) All managers and examiners are responsible for protecting the statute of limitations on penalty assessments. See IRM 25.6, Statute of Limitations.

20.1.5.7  
(01-24-2012)  
**Penalty Relief**

- (1) Reasonable cause and good faith exception to IRC 6662 and IRC 6662A penalties are discussed in this section. See IRM 20.1.1.3, Criteria for Relief From Penalties, for a discussion of general penalty relief.
- (2) Exceptions specific to each accuracy-related penalty, civil fraud penalty, and the erroneous claim for refund or credit penalty are discussed in their respective sections of this IRM.

20.1.5.7.1  
(08-31-2021)  
**Reasonable Cause**

- (1) IRC 6664(c) provides a reasonable cause exception to the penalties under IRC 6662 and IRC 6663 where the taxpayer had reasonable cause and the taxpayer acted in good faith. The reasonable cause exception in IRC 6664(c) applies to all of the components of the accuracy-related penalty on underpayments and the fraud penalty, except for any portion of an underpayment that is attributable to one or more transactions lacking economic substance as described in IRC 6662(b)(6), or that is attributable to a gross valuation over-

statement with respect to charitable deduction property. In addition, there are special reasonable cause rules outlined in IRC 6664(c)(3) for certain substantial valuation overstatements.

- (2) The determination of whether the taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all the relevant facts and circumstances.
- (3) Generally, the most important factor in determining reasonable cause is the taxpayer's effort to report the proper tax liability. Other factors to consider are the taxpayer's experience, knowledge, education, and the taxpayer's reliance on the advice of a tax advisor.
- (4) All relevant facts, including the nature of the tax investment, the complexity of the tax issues, the competence of the tax advisor, the education of the taxpayer, and the quality of the opinion relied upon must be developed to determine whether the taxpayer was reasonable and acted in good faith.
- (5) Examples of types of conduct that may or may not constitute reasonable cause are described in Exhibit 20.1.5-6.
- (6) 26 CFR 1.6664-4T(f) provides guidelines for applying the reasonable cause and good faith exception to IRC 6662(e) penalties for transactions between persons described in IRC 482, Allocation of Income and Deductions Among Taxpayers. For specific reasonable cause criteria on transfer pricing adjustments, see IRM 20.1.5.10.7.1.
- (7) Special rules apply to items of a corporation attributable to a tax shelter resulting in a substantial understatement. See IRM 20.1.5.7.7.
- (8) IRC 6664(d) provides a reasonable cause exception to the IRC 6662A penalty for any portion of a reportable transaction understatement with respect to which there was reasonable cause and the taxpayer acted in good faith.
- (9) Under IRC 6664(d), the reasonable cause exception to the IRC 6662A penalty does not apply unless:
  - a. The relevant facts of the transaction are disclosed in accordance with the regulations prescribed under IRC 6011,
  - b. There is or was substantial authority for such treatment, and
  - c. The taxpayer reasonably believed that the treatment was more likely than not the proper treatment.

**Note:** The reasonable cause exception does not apply to transactions lacking economic substance as described in IRC 6662(b)(6).

- (10) **Reminder:** This section does not apply to IRC 6707A. See IRM 4.32.4, Abusive Transactions, IRC 6707A Penalty for Failure to Include Reportable Transaction Information With Return, for additional guidance.
- (11) For additional guidance see 26 CFR 1.6664-4.
- (12) Partnerships subject to the centralized audit regime are treated as the taxpayer for purposes of the reasonable cause and good faith exception under IRC 6664 and 26 CFR 1.6664-4. Special rules apply to reviewed year partners. Refer to IRM 20.1.5.19 and IRM 20.1.5.19.3.4 for additional information.

20.1.5.7.2  
(07-01-2008)  
**Taxpayer's Effort to Report the Proper Tax Liability**

- (1) Generally, the most important factor in determining whether the taxpayer has reasonable cause and acted in good faith is the extent of the taxpayer's effort to report the proper tax liability. For example, reliance on erroneous information reported on an information return indicates reasonable cause and good faith, provided that the taxpayer did not know or have reason to know that the information was incorrect. Similarly, an isolated computational or transcription error may indicate reasonable cause and good faith.
- (2) Generally, there is reasonable cause and good faith if the taxpayer relies on erroneous information inadvertently included in data compiled by various divisions of a multidivisional corporation or in financial books and records prepared by those divisions. The corporation, however, must have employed internal controls and procedures, reasonable under the circumstances, which were designed to identify factual errors.

20.1.5.7.3  
(07-01-2008)  
**Experience, Knowledge, Sophistication, and Education of Taxpayer**

- (1) Circumstances that may suggest reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of the facts, including the experience, knowledge, sophistication, and education of the taxpayer. The taxpayer's mental and physical condition, as well as sophistication with respect to the tax laws at the time the return was filed, are relevant in deciding whether the taxpayer acted with reasonable cause.
- (2) If the taxpayer is misguided and unsophisticated in tax law, but acts in good faith, a penalty is not warranted.

20.1.5.7.4  
(08-31-2021)  
**Reliance on Advice**

- (1) Reliance upon a tax opinion provided by a professional tax advisor may serve as a basis for the reasonable cause and good faith exception to the accuracy-related penalty. The reliance, however, must be objectively reasonable. For example, the taxpayer must supply the advisor with all the necessary information to assess the tax matter. Similarly, if the advisor suffers from a conflict of interest or lack of expertise that the taxpayer knew or should have known about, the taxpayer might not have acted reasonably in relying on that advisor. The advice also must be based on all pertinent facts, circumstances, and the law as it relates to those facts and circumstances.
- (2) The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. For example, the advice must not be based on a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner. Similarly, the advice must not be based on an assumption that the transaction has a business purpose other than tax avoidance.
- (3) "Advice" is defined as any communication, including the opinion of a professional tax advisor, setting forth an analysis or conclusion by a person other than the taxpayer and on which the taxpayer relied in preparing the return. Advice does not have to be in any particular form.
- (4) Whether a taxpayer reasonably relied on an opinion or advice cannot be determined without reviewing the opinion(s). At times, a taxpayer may refuse to turn over an opinion the taxpayer claims to have relied on or the taxpayer may assert a privilege claim. If the taxpayer refuses to provide the opinion, disallow the taxpayer's position as not being verifiable.

- (5) Whenever the penalty is not asserted because the taxpayer has met the “advice” standard under the reasonable cause exception, contact the professional tax advisor to confirm that the advice was provided and that the standard under the reasonable cause exception is available. This is **mandatory** before the case is closed from the group. This contact is authorized by IRC 6103(k)(6), Disclosure by Certain Officers and Employees for Investigative Purposes. The examiner should be mindful that a preparer of the return may not be the professional tax advisor or person who prepared or provided the advice. Contact with both may be necessary.

**Note:** See IRM 11.3.21.3, Requirements for Investigative Disclosures, for additional guidance and cautions when requesting information from others.

- (6) Whenever a return preparer’s conduct becomes an issue, the examiner should consider the applicability of the return preparer penalties under IRC 6694, Understatement of Taxpayer’s Liability by Tax Return Preparer, and IRC 6695, Other Assessable Penalties With Respect to the Preparation of Tax Returns for Other Persons, and contact the preparer, if necessary. See IRM 20.1.6, Preparer, Promoter, Material Advisor Penalties.
- (7) Examiners should be mindful of the third party contact requirements discussed in IRM 25.27, Third Party Contacts.

20.1.5.7.5  
(12-13-2016)  
**Reportable Transactions**

- (1) For penalties under IRC 6662, the failure of a taxpayer to disclose a reportable transaction is a strong indication that the taxpayer did not act in good faith with respect to the portion of an underpayment attributable to a reportable transaction, as defined under IRC 6011. A taxpayer may argue that the failure to disclose was based on the advice of a tax advisor concluding that the transaction was not reportable.
- (2) A taxpayer’s reliance on an opinion that a transaction is not reportable must be reasonable and made in good faith. An opinion providing that a transaction is not reportable, and, therefore, need not be disclosed is subject to the same scrutiny as the underlying tax opinion or advice. The taxpayer must demonstrate reasonable cause and good faith as described above. See IRM 20.1.5.17 for additional information on reportable transactions.

20.1.5.7.6  
(07-01-2008)  
**Non-tax Matters**

- (1) Where a tax benefit depends on non-tax factors, the taxpayer has a duty to investigate the underlying factors rather than simply relying on statements of another person, such as a promoter. Further, if the tax advisor is not versed in these non-tax matters, mere reliance on the tax advisor does not suffice.

20.1.5.7.7  
(01-24-2012)  
**Special Rules for Corporate Tax Shelter Items**

- (1) If a corporate taxpayer has a substantial understatement that is attributable to a tax shelter item, the accuracy-related penalty applies to that portion of the understatement unless the reasonable cause and good faith exception applies. See 26 CFR 1.6664-4(f).
- (2) A corporation’s legal justification may be taken into account in establishing that the corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item, but **only** if there is substantial authority within the meaning of 26 CFR 1.6662-4(d) for the treatment of the item **and** the corporation reasonably believed when the return was filed, that the treatment was more likely than not the proper treatment. See 26 CFR 1.6664-4(f)(2)(i)(B).

- (3) The **reasonable belief standard** is generally met if either of the following applies:
- a. The corporation analyzed pertinent facts and relevant authorities to conclude in good faith that there would be a greater than 50 percent likelihood (more likely than not) that the tax treatment of the item would be upheld if challenged by the IRS; or
  - b. The corporation reasonably relied in good faith on the opinion of a professional tax advisor who analyzed all the pertinent facts and authorities, and who unambiguously states that there is a greater than 50 percent likelihood that the tax treatment of the item will be upheld if challenged by IRS. See 26 CFR 1.6664-4(c) for requirements with respect to the opinion of a professional tax advisor.

20.1.5.8  
(04-22-2019)  
**IRC 6662(c) and IRC  
6662(b)(1), Negligence or  
Disregard of Rules or  
Regulations**

- (1) The negligence or disregard of rules or regulations under IRC 6662(c) is not limited to underpayments of income tax, but also applies to other underpayments, such as with respect to excise taxes.
- (2) The penalties attributable to negligence and disregard of rules or regulations often overlap, seem to apply equally to any given case, and are often difficult to distinguish. See 26 CFR 1.6662-3(b)(1) and (2) for the definitions of negligence and disregard.
- (3) The amount of the penalty is 20 percent of the underpayment attributable to negligence or disregard of rules or regulations.
- (4) See Exhibit 20.1.5-8 for guidance on calculating an underpayment for a taxpayer with frozen refunds of refundable credits.

20.1.5.8.1  
(12-13-2016)  
**Negligence**

- (1) Negligence includes any failure to make a reasonable attempt to comply with the provisions of the tax law, exercise ordinary and reasonable care in tax return preparation, or keep adequate books and records.
- (2) Negligence is strongly suggested if a taxpayer fails to make a reasonable attempt to ascertain the correctness of a reported item "which would seem to a reasonable and prudent person to be 'too good to be true,' under the circumstances". See 26 CFR 1.6662-3(b)(1)(ii). Other indications of negligence include but are not limited to the following:
  - a. Unreported or understated income.
  - b. Significantly overstated deductions or credits.
  - c. Careless, improper, or exaggerated deductions.
  - d. Misrepresented or miscategorized deductions in such a manner as to conceal the true nature of the deduction.
  - e. Unexplainable items.
  - f. Inadequate books and records.
  - g. Cooperative state programs and state reports showing a negligence penalty (taking into account other factors and not relying entirely on the findings of taxing agency).
  - h. Substantial errors on an issue (e.g., EITC) that had been adjusted in a prior year.
  - i. Incorrect or incomplete information provided to the return preparer for preparation of the tax returns.

- (3) The penalty for negligence **does not** apply if the taxpayer's position has a reasonable basis. If a return position is reasonably based on one or more of the authorities in 26 CFR 1.6662-4(d)(3)(iii), the position will generally satisfy the reasonable basis standard even though it does not rise to the level of substantial authority.
- (4) The negligence penalty **will not** be asserted solely for filing a return late.
- (5) The negligence penalty **will not** be asserted solely due to the taxpayer's failure to appear for an audit or respond to an inquiry or notice unless the taxpayer failed to include on an income tax return an amount of income shown on an information return. In addition, other facts and circumstances from the return and the case file may warrant assertion of the accuracy-related penalty attributable to negligence. Examples are as follows:
- a. An information return processing (IRP) document shows the taxpayer received \$5,000 of interest income. The tax return reflects AGI of \$40,000 but no interest income. The taxpayer does not appear for the examination. The accuracy-related penalty attributable to negligence should be asserted if the facts and circumstances of the case, including the IRP document, information on the return, and information in the case file, demonstrate that it is appropriate.
 

**Note:** Chief Counsel memorandum (POSTN-146385-07, October 22, 2007) emphasizes that regulations (See 26 CFR 1.6662-3(b)(1)(i)) specifically state that negligence is strongly indicated where a taxpayer fails to include on an income tax return an amount of income shown on an information return. Alternatively, information in the case file may include prior year transcripts which could indicate if the taxpayer was notified of the omission of income in prior years. If the taxpayer was notified prior to the current year audit and failed to report all taxable income correctly in the current year, the negligence penalty would further be supported and thus applied.
  - b. The TY 2012 and TY 2013 examinations disallowed the auto expense deduction in both years because the costs were commuting expenses. The TY 2014 return was then filed and secured after these examinations and the taxpayer claimed the same deduction for commuting expenses. The taxpayer did not appear for the office appointment. Based on the prior year's disallowed deduction and the taxpayer's knowledge of the nondeductible expense, the penalty for negligence should be asserted on the TY 2014 return.

20.1.5.8.2  
(04-22-2019)  
**Disregard of Rules or Regulations**

- (1) Disregard of rules or regulations relates to the taxpayer's failure to follow the appropriate law in completing the return, and reflects a disregard of the IRC, temporary or final regulations, revenue rulings, or IRS notices (other than notices of proposed rule making). The term "disregard" includes careless, reckless, or intentional disregard.
- "Careless" if the taxpayer does not exercise reasonable care to determine the correctness of a tax return position that is contrary to the rule or regulation.
  - "Reckless" if the taxpayer makes little or no effort to determine if a rule or regulation exists, under circumstances demonstrating a substantial deviation from a reasonable standard of conduct.

- “Intentional” if the taxpayer knows of a rule or regulation and ignores that rule or regulation.

(2) There is no penalty for a position contrary to a revenue ruling or IRS notice published in the Internal Revenue Bulletin (IRB) if the position has a realistic possibility of being sustained on its merits, except for a reportable transaction as defined in the regulations under IRC 6011. Otherwise, a taxpayer may not avoid a penalty for disregard of a rule or regulation due to a position that did not have a realistic possibility of being sustained on its merits.

20.1.5.8.2.1  
(01-24-2012)  
**Adequate Disclosure**

- (1) The penalty for disregard of rules or regulations does not apply if the taxpayer adequately discloses the position on Form 8275, Disclosure Statement, or Form 8275-R, Regulation Disclosure Statement, (as appropriate). If a taxpayer is required to file a Schedule UTP, (Form 1120), Uncertain Tax Position Statement, for a taxable year, a complete and accurate Schedule UTP that discloses a tax position attached to a return or a qualified amended return will be treated as a Form 8275 or Form 8275-R regarding the tax position.
- (2) In the case of reportable transactions, taxpayers also must disclose transactions on Form 8886, Reportable Transaction Disclosure Statement, as required under IRC 6011.
- (3) The penalty does not apply to a position that is contrary to a regulation if the taxpayer discloses the position and the position represents a good faith challenge to the regulation. A good faith challenge to the validity of a regulation generally requires a showing that the taxpayer conducted a careful analysis of reasonably available authorities relating to the issue including:
- a. Statutory language,
  - b. Legislative history,
  - c. Underlying Treasury Decision, and
  - d. Relevant case law (including case law pertaining to the presumption of validity to which regulations are entitled).

The persuasiveness of the rationale supporting the contrary position should also be taken into account in determining whether the taxpayer’s position represents a good faith challenge to the validity of a regulation.

- (4) The adequate disclosure exception does not apply if the position with respect to a rule or regulation does not have a reasonable basis, if the taxpayer fails to keep adequate books and records, or if the taxpayer fails to substantiate records properly.
- (5) Courts have also held that a disclosure statement is adequate if it reasonably apprises the IRS of the nature and amount of the potential controversy. The disclosure statement should include the following:
- a. A caption identifying the statement as a disclosure under IRC 6662,
  - b. An identification of the item with respect to which the disclosure is made,
  - c. The amount of the item, and
  - d. The facts affecting the tax treatment of the item sufficient to apprise the IRS of the nature of the potential controversy.

**Note:** If the disclosure statement fails to include all of the above, misrepresents the facts, or is too general to reasonably apprise the IRS of the potential controversy, the disclosure exception does not apply.

- (6) Adequate disclosure is an exception to the penalty attributable to disregard of rules or regulations. Since the penalty attributable to negligence is not subject to a disclosure exception, the distinction between negligence and disregard of rules and regulations will sometimes have to be made.
- (7) The applicability of the disclosure exception is determined for each item or group of similar items separately.
- (8) When the adequate disclosure exception is met, the tax attributable to the disclosed item is not included in the calculation of the underpayment for penalty purposes.
- (9) See 26 CFR 1.6662-3(c), 26 CFR 1.6662-4(f)(1),(3),(4,) and (5) regarding methods of adequate disclosure.

20.1.5.8.2.1.1  
(08-31-2021)  
**Special Rules for  
Disclosure**

- (1) **Coordinated Industry Case (CIC) Program (for years prior to 2017), and the Large Corporate Compliance (LCC) Program (2017 and later):** Rev. Proc. 94-69, 1994-2 C.B. 804, provides special rules for CIC and LCC taxpayers to meet the adequate disclosure exception by providing a written statement after receiving written notice from the IRS requesting such statement.
- (2) **Pass-through entities:** Generally, disclosure for items attributable to a pass-through entity should be made on Form 8275 or Form 8275-R and attached to the return (or qualified amended return) of the entity. Also, a taxpayer (e.g., partner, shareholder, beneficiary, or holder of a residual interest in a REMIC) may make adequate disclosure by filing Form 8275 or Form 8275-R. See applicable form instructions for additional information on filing requirements for Form 8275 or Form 8275-R.
- (3) **Recurring items:** Disclosure with respect to a recurring item, such as the basis of recovery property, must be made with each return on which the item is taken into account.
- (4) **Significant book-tax difference:** In certain circumstances, a taxpayer is deemed to satisfy the disclosure requirements by disclosing on a Schedule M-3 each item of income, gain, loss, deduction, or credit for which the difference between the amount included in the taxpayer's financial statement net income (loss) for the taxable year and the amount included in taxable income for the taxable year is greater than \$10 million. See Rev. Proc. 2004-45, 2004-31 IRB 140.

20.1.5.9  
(08-31-2021)  
**IRC 6662(d) and IRC  
6662(b)(2), Substantial  
Understatement**

- (1) The substantial understatement penalty is limited to understatement of income tax.
- (2) An **understatement** is the excess of the amount of the following:
  - a. The tax required to be shown on the return, over
  - b. The amount of tax imposed, which is shown on the return, reduced by any rebate.

See 26 CFR 1.6662-4(b)(2). The excess amount is determined without regard to items to which IRC 6662A applies.

- (3) An understatement is **substantial** if it exceeds the greater of the following:

- a. 10 percent of the tax required to be shown on the return for a taxable year; or
  - b. \$5,000.
- (4) The Tax Cuts and Jobs Act (TCJA) added IRC 6662(d)(1)(C), which provides a special rule for any taxpayer claiming a deduction under IRC 199A. For taxable years beginning after December 31, 2017, for any taxpayer claiming a deduction under IRC 199A, an understatement is **substantial** if it exceeds the greater of the following:
- a. 5 percent of the tax required to be shown on the return; or
  - b. \$5,000
- (5) A corporation (other than an S corporation or a personal holding company) has a substantial understatement of income tax if the amount of the understatement exceeds the lesser of the following:
- a. 10 percent of the tax required to be shown on the return for a taxable year (or, if greater, \$10,000), or
  - b. \$10,000,000.
- (6) For purposes of determining whether an understatement is substantial, the amount of the understatement is increased by the aggregate amount of reportable transaction understatements. See IRM 20.1.5.17 for further information relating to reportable transaction understatements.
- (7) The substantial understatement penalty applies only to the excess of the amount of the substantial understatement (after determining that a substantial understatement exists) over the aggregate amount of the reportable transaction understatements. Thus, the substantial understatement penalty does not apply to any amount attributable to a reportable transaction understatement and subject to IRC 6662A.
- (8) Special rules apply for calculation of the substantial understatement penalty for partnership adjustments under the centralized partnership audit regime. See IRM 20.1.5.19, Bipartisan Budget Act of 2015 - Penalties with Respect to Partnership Adjustments.
- (9) The substantial understatement penalty will be considered for assertion on all discretionary and EITC cases not worked solely through automation.
- (10) When the substantial understatement penalty is applicable, it should be included on the audit report to the taxpayer.

20.1.5.9.1  
(04-22-2019)

**Exceptions to the  
Substantial  
Understatement Penalty**

- (1) The amount of an understatement is reduced by that portion of the understatement attributable to the following:
- a. An item for which there is or was substantial authority (IRC 6662(d)(2)(B)(i)), or
  - b. An item the relevant facts of which were adequately disclosed and for which there is a reasonable basis (IRC 6662(d)(2)(B)(ii)).
- (2) Special rules apply in the case of a tax shelter item. See IRM 20.1.5.9.1.3.
- (3) See 26 CFR 1.6662-4(d), Substantial Authority.

- (4) See 26 CFR 1.6662-4(e), Disclosure of Certain Information and 26 CFR 1.6662-4(f), Method of Making Adequate Disclosure.
- (5) IRC 6664(c)(1) provides an exception to the substantial understatement penalty if the taxpayer has reasonable cause and acted in good faith. See IRM 20.1.5.7.1, Reasonable Cause.

20.1.5.9.1.1  
(12-13-2016)

**Substantial Authority Exception**

- (1) Substantial authority is an objective standard involving an analysis and application of the law to the relevant facts. It is not determined with reference to what the taxpayer actually believed to be the correct treatment of the item. Every item must be separately evaluated to determine whether there is substantial authority for the tax treatment of an item. See 26 CFR 1.6662-4(d)(3)(iv)(C).
- (2) Substantial authority for the tax treatment of an item will exist in the following situations:
  - a. If there is substantial authority at the time the return containing the item is filed, or
  - b. If there was substantial authority on the last day of the taxable year to which the return relates.
- (3) There is substantial authority if the weight of the authorities supporting the treatment of the item is substantial in relation to the weight of the authorities supporting the contrary treatment. See 26 CFR 1.6662-4(d)(3)(i) and Exhibit 20.1.5-7 for additional information regarding supporting authorities.

20.1.5.9.1.2  
(04-22-2019)

**Adequate Disclosure for Purposes of Reducing an Understatement of Tax**

- (1) When the adequate disclosure exception is met, the tax attributable to the disclosed item or return position is not included in the calculation of the understatement for penalty purposes.
- (2) Revenue procedures provide annual guidance concerning when information shown on a return in accordance with the applicable forms and instructions will be adequate disclosure for purposes of reducing an understatement of income tax under IRC 6662(d) and IRC 6694(a) only.
  - a. For 2018 returns, see Rev. Proc. 2019-9
  - b. For 2017 returns, see Rev. Proc. 2018-11
  - c. For 2015 returns, see Rev. Proc. 2016-13.
  - d. For 2014 returns, see Rev. Proc. 2015-16.
  - e. For 2013 returns, see Rev. Proc. 2014-15.
  - f. For 2012 returns, see Rev. Proc. 2012-51
  - g. For 2011 returns, see Rev. Proc. 2012-15.
  - h. For prior years, review the annual revenue procedures published by the IRS in the Internal Revenue Bulletins for the applicable tax year.

**Note:** A Rev. Proc. was not issued to cover 2016 returns.

20.1.5.9.1.3  
(08-31-2021)

**Exceptions for Tax Shelter Items**

- (1) For purposes of the substantial understatement penalty, tax shelter includes, among other things, any plan or arrangement with a significant purpose of avoidance or evasion of federal income tax.
- (2) In general, no taxpayer may reduce an understatement attributable to a tax shelter item on account of the following:

- a. Substantial authority, or
- b. Adequate disclosure and reasonable basis.

**Note:** 26 CFR 1.6662-4(g), Items Relating to Tax Shelters, has been effectively obsolete by subsequent statutory amendments.

20.1.5.9.2  
(08-31-2021)  
**Penalty Assertion**

- (1) The substantial understatement penalty can be asserted only when the understatement is determined to be substantial.
- (2) When the understatement is substantial, but the penalty is not asserted, the examiner should explain the applicable exceptions in the case file.
- (3) Written Supervisory approval is required when the understatement is substantial whether or not the penalty is asserted.
- (4) Examiner will identify the penalty attributable to each adjustment in the report and explain each penalty by name, IRC section, and calculated penalty amount.
- (5) The penalty can be asserted on “no show” cases (as defined by IRM 4.10.2.8.3) when the following occurs:
  - a. The understatement is substantial, and
  - b. The taxpayer does not appear to meet any exceptions.
- (6) When the accuracy-related penalty attributable to a substantial understatement of income tax is not asserted due to the assertion of negligence or disregard of rules or regulations, any unagreed report will include the substantial understatement penalty as an alternative penalty position.
- (7) The preparer penalties under IRC 6694 must be considered and documented for all substantial understatement penalty cases with taxpayer contact. Preparer penalties are discussed in IRM 20.1.6, Preparer, Promoter, Material Advisor Penalties.

20.1.5.9.3  
(01-24-2012)  
**Penalty Calculation**

- (1) The examiner will determine the substantial understatement penalty amount by completing the following actions:
  - a. Calculate the understatement.
  - b. Establish that the understatement is substantial.
  - c. Consider whether to reduce the amount of the understatement. If there should be a reduction, recalculating the understatement without including the tax on the adjustments not subject to the penalty.
  - d. Determine whether the understatement is substantial after applying the reduction.
  - e. Consider adjustments for prepayment and refundable credits.
  - f. Apply the penalty rate to the underpayment to arrive at the penalty amount.

**Note:** See Exhibit 20.1.5-8 for guidance on calculating an underpayment for a taxpayer with a frozen refund of refundable credits.

- (2) For calculation examples, see Exhibit 20.1.5-2 & Exhibit 20.1.5-3.

- 20.1.5.10  
(04-22-2019)  
**IRC 6662(e) and IRC 6662(b)(3), Substantial Valuation Misstatement**
- (1) For the accuracy-related penalty to apply in the case of a substantial valuation misstatement, the portion of the underpayment attributable to a substantial valuation misstatement must exceed \$5,000 (\$10,000 in the case of a corporation other than an S corporation or a personal holding company).
  - (2) The amount of the penalty is 20 percent of the underpayment attributable to a substantial valuation misstatement and 40 percent in the case of a gross valuation misstatement.
- 20.1.5.10.1  
(12-13-2016)  
**IRC 6662(e)(1)(A), Substantial Valuation Misstatement**
- (1) A substantial valuation misstatement exists if the value or adjusted basis of any property claimed on a return is 150 percent or more of the amount determined to be the correct amount of such value or adjusted basis. See IRC 6662(e)(1)(A).
- 20.1.5.10.2  
(12-13-2016)  
**IRC 6662(e)(1)(B), Valuation Misstatement Penalties for Transfer Pricing Transactions Under IRC 482**
- (1) IRC 6662(e)(1)(B) imposes an accuracy-related penalty on any underpayment attributable to a substantial valuation misstatement pertaining to transfer pricing under IRC 482. These penalties are identified as the transactional penalty and the net adjustment penalty.
  - (2) **Transactional Penalty:** This penalty applies when the price reported for any property or services is 200 percent or more (or 50 percent or less) of the amount determined under IRC 482 to be the correct price.
  - (3) **Net Adjustment Penalty:** This penalty applies when the net IRC 482 adjustment exceeds the lesser of \$5 million or 10 percent of the taxpayer's gross receipts.
  - (4) The term "price for any property or services" encompasses all kinds of adjustments under IRC 482, including purchase prices, fees, services, rents, interest, and advances.
  - (5) See IRC 6662(e)(3)(B) for the net IRC 482 adjustments that are excluded from the penalty.
  - (6) See 26 CFR 1.6662-6(c)(7) for calculation examples of penalty application to IRC 482 adjustments.
  - (7) See Exhibit 20.1.5-3 flow chart for the IRC 6662(e) transfer pricing penalty.
- 20.1.5.10.3  
(12-13-2016)  
**IRC 6662(h), Gross Valuation Misstatement**
- (1) A gross valuation misstatement exists in the following:
    - a. If the value or adjusted basis of any property claimed on a return is 200 percent or more of the corrected amount,
    - b. If the price for any property or service (or for the use of property) claimed on a return is 400 percent or more (or 25 percent or less) of the amount determined under IRC 482 to be the correct price, or
    - c. If the net IRC 482 adjustment exceeds the lesser of \$20,000,000 or 20 percent of the taxpayer's gross receipts.
- 20.1.5.10.4  
(12-13-2016)  
**Penalty Assertion**
- (1) The examiner is responsible for the assertion of the accuracy-related penalty attributable to a valuation misstatement.
  - (2) See IRC 6662(e)(1)(B) relating to substantial valuation misstatements under IRC 482 transactions.

- (3) If the value or adjusted basis of any property claimed on a return is 200 percent or more of the amount determined to be the correct amount of such value or adjusted basis, the valuation misstatement constitutes a “gross valuation misstatement.” See IRC 6662(h)(2)(A). If there is a gross valuation misstatement, then the 20 percent penalty under IRC 6662(a) is increased to 40 percent. See IRC 6662(h)(1).
- (4) There is no disclosure exception to this penalty.
- (5) The substantial valuation misstatement penalty does not apply to any understatement upon which a penalty under IRC 6662A is imposed. IRC 6662A does not apply to any understatement upon which the gross valuation misstatement penalty is imposed.

20.1.5.10.5  
(12-13-2016)

#### Penalty Calculation

- (1) In the example below, the substantial valuation misstatement penalty applies to the individual income tax return because of the following:
  - a. The portion of the underpayment for the taxable year exceeds \$5000 as required by IRC 6662(e)(2), and
  - b. The value of the property (or adjusted basis of the property) claimed is 150 percent or more of the amount determined to be correct valuation or adjusted basis per IRC 6662(e)(1)(A).

**Example:** A taxpayer reported the price (value) of the property sold as \$106,000. During the course of an examination, the IRS determined that the correct value of the property is \$65,000.

Reference Items	Description	Amounts
a)	Value of property as reported on the return	106,000
b)	Value as adjusted by examination	65,000
c)	150 percent times the amount in (b)  IRC 6662(e)(1)(A) is met. The value reported on the return of \$106,000 is more than 150 percent of the adjusted by examination amount of \$65,000 (\$106,000 divided by \$65,000 = 163 percent).	97,500
d)	Amount adjusted (line “a” less line “b”)	41,000
e)	Underpayment on \$41,000	10,250

Reference Items	Description	Amounts
f)	Penalty (20 percent times \$10,250)  IRC 6662(e)(2) is met as required. The underpayment of \$10,250 attributable to the misstatement of \$41,000 exceeds \$5,000.	2,050

- (2) If the adjusted value in (b) above was \$35,000, the amount reported of \$106,000 would then exceed the adjusted amount (\$35,000) by more than 200 percent (\$106,000 divided by \$35,000 = 303 percent). The gross valuation misstatement penalty would then apply at 40 percent of the applicable underpayment.
- (3) For calculation examples involving carryovers and flow through entities, see IRM 20.1.5.3.4 .
- (4) The penalty is considered separately for each property adjusted. To distinguish between a substantial and a gross valuation misstatement requires a property-by-property calculation.
- (5) With regard to the transfer pricing penalty under IRC 6662(e), please refer to the rules for coordinating between the transactional penalty and the net adjustment penalty illustrated by examples in 26 CFR 1.6662-6(f).

20.1.5.10.6  
(01-24-2012)

**Penalty Assessments  
and Abatements**

- (1) See IRM 20.1.5.4.2 for policies and procedures regarding the assessment and abatement of IRC 6662(h).

20.1.5.10.7  
(01-24-2012)

**Penalty Relief**

- (1) See IRM 20.1.5.7 for general information regarding relief of IRC 6662(h).

20.1.5.10.7.1  
(01-24-2012)

**Reasonable Cause**

- (1) IRC 6664(c) provides an exception to the penalty if the taxpayer has reasonable cause and acted in good faith.
- (2) The reasonable cause exception applies to the transfer pricing penalties only under certain circumstances. See IRC 6662(e)(3)(D).
  - a. For the transactional penalty, see IRM 20.1.5.10.2 and IRC 6662(e)(1)(B)(i). A taxpayer must meet the reasonable cause requirements to avoid the penalty.
  - b. For the net adjustment penalty, see IRM 20.1.5.10.2.
- (3) In instances where a taxpayer has relied on a professional analysis in determining transfer pricing, the relationship of the professional is not determinative in evaluating whether the taxpayer reasonably relied in good faith on advice.

20.1.5.10.7.2  
(12-13-2016)  
**Charitable Deduction  
Property**

- (1) The reasonable cause exception under IRC 6664(c) does not apply to an underpayment attributable to a gross valuation misstatement with respect to charitable deduction property. See IRC 6664(c)(3).
- (2) The reasonable cause exception under IRC 6664(c) may apply to an underpayment attributable to a substantial valuation misstatement with respect to charitable deduction property if:
  - a. The claimed value of the property was based on a “qualified appraisal” made by a “qualified appraiser,” and
  - b. The taxpayer made a good faith investigation of the value of the contributed property.
- (3) The taxpayer will not satisfy the reasonable cause exception by merely meeting requirements of IRC 6664(c)(3). The taxpayer must also meet the requirements of 26 CFR 1.6662-4(b) and (c).
- (4) The Pension Protection Act of 2006 added a penalty provision under IRC 6695A. If the claimed value of property based on an appraisal results in a substantial or gross valuation misstatement under IRC 6662, an IRC 6695A penalty may be imposed on any person who prepared the appraisal and who knew, or reasonably should have known, the appraisal would be used in connection with a return or claim for refund. See IRM 20.1.12, Penalties Applicable to Incorrect Appraisals.

20.1.5.11  
(04-22-2019)  
**IRC 6662(f) and IRC  
6662(b)(4), Substantial  
Overstatement of  
Pension Liabilities**

- (1) The amount of the substantial overstatement of pension liabilities penalty is 20 percent of the underpayment attributable to a substantial overstatement of pension liabilities and 40 percent of the underpayment attributable to a gross valuation misstatement (IRC 6662(h))
- (2) An overstatement of pension liabilities occurs when the actuarial determination of the liabilities taken into account for purposes of computing the employer contribution deduction under IRC 404(a) is 200 percent or more of the correct amount (400 percent or more in the case of a gross valuation misstatement).
- (3) The penalty does not apply unless the underpayment attributable to the substantial overstatement of pension liabilities (or gross valuation misstatement, if applicable) exceeds \$1,000.

20.1.5.11.1  
(01-24-2012)  
**Penalty Calculation**

- (1) The following illustrates the penalty criteria and calculation:
  - a. The taxpayer’s return had taxable income of \$300,000 and tax of \$98,000.
  - b. In determining the amount of taxable income, the taxpayer deducted \$80,000 for contributions to a defined benefit pension plan maintained for its employees.
  - c. Upon examination of the taxpayer’s return, the IRS adjusted the interest assumption in valuing the pension liabilities for calculating the deduction.
  - d. The taxpayer’s maximum deduction for contributions to its plan was accordingly adjusted from \$80,000 to \$35,000.

**Note:** The 200 percent requirement is met when the amount deducted on the return (\$80,000) exceeds the correct amount (\$35,000) by more than 200 percent ( $\$80,000 \div \$35,000 = 229$  percent). The penalty is calculated as follows:

Reference Items	Calculation	Amounts
a)	Taxable income as adjusted (\$300,000 + \$45,000)	\$345,000
b)	Tax liability as adjusted	\$111,500
c)	Tax liability as filed	\$98,000
d)	Underpayment ("b" less "c")	\$13,500
e)	Penalty rate	20 percent
f)	Penalty ("d" times "e")	\$2,700

- (2) Since the deduction claimed exceeds the corrected amount by more than 200 percent but is less than 400 percent, the penalty applies at the 20 percent rate. If the corrected deduction were \$18,000, the percentage of the overstatement would be 444 percent (\$80,000 divided by \$18,000) and the penalty would apply at the 40 percent rate.

20.1.5.11.2  
(04-22-2019)  
**Penalty Relief**

- (1) The penalty will not apply if the taxpayer shows that there was a reasonable cause for the valuation or assumptions used in deriving the deduction on the return and that the taxpayer acted in good faith.
- (2) See IRM 20.1.5.7 for additional penalty relief criteria.

20.1.5.12  
(04-22-2019)  
**IRC 6662(g) and IRC 6662(b)(5), Substantial Estate or Gift Tax Valuation Understatement**

- (1) The amount of the substantial estate or gift tax valuation understatement penalty is 20 percent of the underpayment attributable to a substantial estate or gift tax valuation understatement, or it is 40 percent of the underpayment attributable to a gross valuation misstatement.
- (2) This penalty applies only to returns of tax imposed for estate or gift taxes.

20.1.5.12.1  
(07-01-2008)  
**Penalty Assertion**

- (1) There is a substantial estate or gift tax valuation understatement if the value of the property claimed on an estate or gift tax return is 65 percent or less of the corrected amount (or 40 percent or less in the case of a gross valuation misstatement). See IRC 6662(g)(1) and IRC 6662(h)(2)(C) respectively.
- (2) The penalty does not apply unless the underpayment attributable to the substantial estate or gift tax valuation understatement (or gross valuation misstatement, if applicable) exceeds \$5,000.

20.1.5.12.2  
(01-24-2012)  
**Penalty Calculation**

- (1) The determination of whether the percentage threshold for a substantial or gross valuation misstatement is reached is made on a property-by-property basis. The percentage threshold is determined by dividing the value of the property reported on the return by the corrected value of the property.
- (2) The following example illustrates the calculation of the understatement percentage for three adjustments (assuming the \$5,000 requirement is met and no exceptions to the penalty apply).

**Example:** The decedent's estate tax return included stock in three closely held corporations: A, B, and C. On the return, the stock in corporation A was

valued at \$200,000 and the stock in corporation B and C was valued at \$80,000 each. On examination, the corrected stock values were determined to be \$270,000 for A, \$190,000 for B, and \$330,000 for C. The following determinations were made.

- a. Stock A: The amount on the return (\$200,000) divided by the corrected amount (\$270,000) is 74 percent. The penalty does not apply to this adjustment because the value of the stock is not 65 percent or less of the corrected amount.
  - b. Stock B: The amount on the return (\$80,000) divided by the corrected amount (\$190,000) is 42 percent. The accuracy-related penalty attributable to a substantial estate or gift tax valuation understatement applies to this adjustment because the value of Stock B is 65 percent or less (but more than 40 percent) of the corrected amount. The penalty amount is 20 percent of the underpayment attributable to the adjustment for Stock B.
  - c. Stock C: The amount on the return (\$80,000) divided by the corrected amount (\$330,000) is 24 percent. The accuracy-related penalty attributable to a gross valuation misstatement applies to this adjustment because the value of Stock C is 40 percent or less of the corrected amount. The penalty amount is 40 percent of the underpayment attributable to the adjustment for Stock C.
- (3) For calculation examples that relate to the above adjustments, see Exhibit 20.1.5-4.

20.1.5.12.3  
(07-01-2008)  
**Penalty Assessments  
and Abatements**

- (1) See IRM 20.1.5.4.2 for policies and procedures regarding the assessment and abatement of IRC 6662(g).

20.1.5.12.4  
(01-24-2012)  
**Penalty Relief**

- (1) Penalty relief may be available under certain circumstances if a taxpayer acquired property from a decedent who died in 2010.
- (2) Special rules may apply in determining tax items including basis, gain, loss, holding period, and character of the acquired property. Section 301(c) of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, P. L. 111-312, allows the executor of the estate of any decedent who died in 2010 to elect not to have the estate tax rules apply and instead to have modified carryover basis rules apply. This election could impact the amount of tax owed. See Pub 4895, Tax Treatment of Property Acquired From a Decedent Dying in 2010.
- (3) A taxpayer acquiring property from a decedent may not know whether the executor will elect not to have the estate tax rules apply to the decedent's estate. Thus, a taxpayer may be entitled to penalty relief, for example, when a taxpayer acquired property from a decedent who died in 2010 and sold the same property in 2010. If the taxpayer filed a timely extension to file his or her income tax return, estimated the gain or loss from such a sale, and made any other estimates for the acquired property necessary to compute the tax, and it is later determined that the taxpayer owes additional tax because the estimate is incorrect, penalty relief will be considered if the estimate was based on a reasonable interpretation of the law.
- (4) See IRM 20.1.5.7 for additional information on penalty relief.

20.1.5.13  
(04-22-2019)  
**IRC 6662(b)(6), Penalty for Underpayments Attributable to a Transaction Lacking Economic Substance**

- (1) An accuracy-related penalty is imposed under IRC 6662(b)(6) on an underpayment attributable to a transaction lacking economic substance as defined under IRC 7701(o) or failing to meet the requirements of any similar rule of law.
- (2) Guidance is provided in *Notice 2010-62*. Further guidance is provided in IRM 4.46.4.11.9, Economic Substance Doctrine, and Exhibit 4.46.4-4, Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties.
- (3) The penalty for underpayments attributable to transactions lacking economic substance is equal to 20 percent of the underpayment.
- (4) The penalty applies to transactions entered into on or after March 31, 2010.

20.1.5.13.1  
(12-13-2016)  
**IRC 6662(i), Increase in Penalty in Case of Nondisclosed Noneconomic Substance Transactions**

- (1) If any portion of an underpayment is attributable to one or more nondisclosed noneconomic substance transactions, the penalty increases to 40 percent as defined under IRC 6662(i).
- (2) Nondisclosed noneconomic substance transaction means any portion of a transaction described in IRC 6662(b)(6) where the relevant facts affecting the tax treatment are not adequately disclosed in the return or in a statement attached to the return. A taxpayer will be deemed to have adequately disclosed only if it provides the required information on Form 8275 or Form 8275-R, or on Schedule UTP (Form 1120), Uncertain Tax Position Statement, if required to file such schedule.
- (3) If the transaction is also a reportable transaction pursuant to 26 CFR 1.6011-4, the taxpayer has not adequately disclosed the transaction unless it is reported both in accordance with the reportable transaction reporting rules and on Form 8275, Form 8275-R, or Schedule UTP (or any subsequently issued form or schedule). Also, a taxpayer will be deemed to have adequately disclosed if it makes a disclosure consistent with the terms of Rev. Proc. 94-69.
- (4) The penalty applies to such underpayment on a return filed before the date the taxpayer is first contacted by the IRS and is not reduced by any amendments or supplements to a tax return filed after the date the taxpayer is first contacted by the IRS.

20.1.5.13.2  
(04-22-2019)  
**Penalty Administration**

- (1) Each operating division will be responsible for developing procedures to administer the IRC 6662(b)(6) and IRC 6662(i) penalties. At a minimum, each operating division's procedures will include the following:
  - a. A requirement of written executive approval to assert the penalties.
  - b. Documentation of the executive approval must be maintained in the case file.
- (2) Refer to IRM 4.46.4.11.9, Economic Substance Doctrine for additional information.
- (3) Each operating division's procedures will be cited for cross-referencing in IRM 20.1.5.
- (4) When closing the case from the group, the examiner will do the following:

- a. Identify the adjustment in the report relating to the IRC 6662(i) penalty and provide the penalty computation in the workpapers.
  - b. Complete and attach Form 3198 or Form 3198–A to identify the IRC section and penalty amount for CCP.
  - c. Use the appropriate closing record and enter the PRN 780 for the 20 percent penalty or PRN 781 for the 40 percent penalty and the positive penalty amount to assess the penalty. See IRM 20.1.5.4.2.
- 20.1.5.13.3  
(12-13-2016)  
**Penalty Relief**
- (1) Reasonable cause does not apply to any transactions lacking economic substance entered into on or after March 31, 2010. See IRC 6664(c)(2) and IRC 6662(b)(6).
- 20.1.5.14  
(08-30-2017)  
**IRC 6662(b)(7) and IRC 6662(j), Undisclosed Foreign Financial Asset Understatement**
- (1) The undisclosed foreign financial asset understatement penalty is 40 percent of the portion of the understatement attributable to any transaction involving an undisclosed foreign financial asset.
  - (2) An undisclosed foreign financial asset is any asset with respect to which information is required to be provided under IRC 6038, IRC 6038B, IRC 6038D, IRC 6046A, or IRC 6048 but was not reported on the return or on a statement as required under the provisions of these IRC sections.
  - (3) The penalty is effective and applies to tax year beginning after March 18, 2010.
  - (4) Contact your divisional counsel or your local technical advisor prior to assertion of this penalty for additional guidance.
- 20.1.5.15  
(08-30-2017)  
**IRC 6662(b)(8) and IRC 6662(k), Inconsistent Estate Basis Reporting**
- (1) An accuracy-related penalty is imposed under IRC 6662(b)(8) on an underpayment attributable to any inconsistent estate basis.
  - (2) There is an “inconsistent estate basis” if the basis of property claimed on a return exceeds the basis as determined under IRC 1014(f).
  - (3) The penalty is effective for property with respect to which an estate tax return is filed after July 31, 2015.
- 20.1.5.15.1  
(08-31-2021)  
**IRC 6662(b)(9) and IRC 6662(l), Overstatement of Qualified Charitable Contributions**
- (1) If any portion of an underpayment is attributable to one or more overstatements of the deduction provided in IRC 170(p), the 20 percent penalty under IRC 6662(a) is increased to 50 percent as defined under IRC 6662(l).
  - (2) IRC 170(p) provides a special rule for taxpayers who do not elect to itemize deductions. Individuals are allowed a deduction for charitable contributions made in cash up to a maximum of \$300 (\$600 for joint returns).
  - (3) The 50 percent penalty will be applied to the portion of the underpayment of tax related to the overstatement of the deduction.
  - (4) The penalty is effective for tax years beginning after December 31, 2020.
  - (5) IRC 6751(b)(2)(A) excludes IRC 6662(b)(9) from the requirement of written approval by the immediate supervisor prior to assessment.

20.1.5.16  
(04-22-2019)  
**IRC 6663, Civil Fraud  
Penalty**

- (1) IRC 6663(a) provides that if any underpayment of tax is due to fraud, a penalty is imposed equal to 75 percent of the portion of the underpayment due to fraud.
- (2) For purposes of IRC 6663, a portion of the underpayment will be considered due to fraud when the intent is to evade tax.

20.1.5.16.1  
(04-22-2019)  
**Indications of Fraud**

- (1) IRC 6663 does not define **fraud**. Courts have long recognized that the essence of the fraud penalty is the state of mind. The state of mind has been described in various ways but most definitions require **intent to evade tax**. Intent is distinguished from inadvertence, reliance on incorrect professional advice, honest difference of opinion, negligence, or carelessness.
- (2) Because direct proof of a taxpayer's fraudulent intent is rarely available, fraud must be proven by circumstantial evidence and reasonable inferences. Fraud will generally involve one or more of the following:
  - a. Deception
  - b. Misrepresentation of material facts
  - c. False or altered documents
  - d. Evasion (e.g., diversion or omission)
  - e. Conspiracy
- (3) Some common indicators of fraud include the following:
  - a. Understatement of income (e.g., by omissions of specific items or entire sources of income, failure to report substantial amounts of income received)
  - b. Fictitious or improper deductions (e.g., overstatement of deductions, personal items deducted as business expenses)
  - c. Accounting irregularities (e.g., two sets of books, false entries on documents)
  - d. Acts of the taxpayer evidencing an intention to evade tax (e.g., false statements, destruction of records, transfer of assets)
  - e. A consistent pattern over several years of underreporting taxable income
  - f. Implausible or inconsistent explanations of behavior
  - g. Failure to cooperate with the examining agent
  - h. Concealment of assets
  - i. Engaging in illegal activities (e.g., drug dealing), or attempting to conceal illegal activities
  - j. Inadequate records
  - k. Dealing in cash

See IRM 25.1.2, Fraud Handbook, Recognizing and Developing Fraud, for extensive lists of examples of fraud indicators.

- (4) Recommendations for asserting the civil fraud penalty should be carefully reviewed to fully establish that the evidence supports the assertion. Fraud must be proven by clear and convincing evidence.
- (5) All statutory notices of deficiency asserting the civil fraud penalty must be reviewed by division counsel.

20.1.5.16.2  
(08-31-2021)  
**Penalty Assertion**

- (1) Civil fraud penalty will be asserted when there is clear and convincing evidence to prove that some part of the underpayment of tax was due to civil fraud. Such evidence must show the taxpayer's intent to evade tax that the taxpayer believed to be due and owing.
- (2) To assert the civil fraud penalty in a tax case, it is necessary to establish that a part of the underpayment is due to a knowingly false representation of facts by the taxpayer. The IRS bears the burden of proving civil fraud by clear and convincing evidence. See IRC 7454(a), Burden of Proof in Fraud, Foundation Manager, and Transferee Cases. The IRS must show that the taxpayer knew the content of the return was false and filed the return with the intent to evade tax.
- (3) The civil fraud penalty should be asserted on a case-by-case basis giving consideration to all factors that have a bearing on the taxpayer's fraudulent intent.
- (4) **Determination of Portion Attributable to Fraud** - If any portion of the underpayment is attributable to fraud, then the entire underpayment shall be treated as attributable to fraud, except with respect to any portion of the underpayment which the taxpayer establishes (by a preponderance of the evidence) is not attributable to fraud. See IRC 6663(b).
- (5) Special rules apply for calculation of the fraud penalty for partnership adjustments under the centralized partnership audit regime. See IRM 20.1.5.19, Bipartisan Budget Act of 2015 - Penalties with Respect to Partnership Adjustments.
- (6) **Qualified Amended Return** - If a taxpayer submits an amended return, it does not cure the defects on the previously filed fraudulent return and the civil fraud penalty would apply. Under 26 CFR 1.6664-2(c)(2), if the understatement on the original return is due to fraud, the tax shown on the amended return is not included in the amount shown as the tax by the taxpayer on the return, for establishing the amount of the underpayment in determining the fraud penalty under IRC 6663. A qualified amended return is defined under 26 CFR 1.6664-2(c)(3).
- (7) The civil fraud penalty cannot be asserted on the same underpayment (or portion of an underpayment) on which accuracy-related penalties are asserted. Only one penalty can be applied to any portion of an underpayment of tax. See IRC 6662(b).
- (8) The criteria for proving fraudulent failure to file under IRC 6651(f) and civil fraud under IRC 6663 are the same. Generally, if a fraudulent return is filed late, IRC 6651(f) is the appropriate penalty to assert. Although there is no specific prohibition against asserting penalties under both IRC 6651(f) and IRC 6663, the examiner should exercise caution. The court is not likely to sustain the assertion of both penalties unless compelling facts support the IRS's position. Divisional counsel should be consulted before asserting either penalty or, if appropriate, both penalties on the same return. See IRM 20.1.2.3.7.5, Fraudulent Failure to File—IRC 6651(f), for additional information regarding restrictions on the assertion of the civil fraud penalty with respect to the fraudulent failure to file penalty.
- (9) On a joint return, the civil fraud penalty does not apply to a spouse unless some part of the underpayment is due to civil fraud on the part of that spouse. See IRC 6663(c).

- a. For taxpayers filing a joint return after having filed separate returns, see IRC 6013(b)(5).
  - b. The civil fraud penalty follows the IRC provision that allows a married couple to file a joint return after separate returns have been filed.
  - c. If the sum of the amounts shown as tax on the two separate returns (for example, \$150 plus \$100 = \$250) is less than the amount shown as tax on the joint return (for example, \$300), then for the purpose of computing the civil fraud penalty, the sum of the amounts shown on the separate returns is treated as the amount shown on the joint return.
  - d. Any fraud on a separate return will be deemed to be fraud on the joint return.
- (10) As a general rule, examiners in LB&I, SB/SE, TE/GE, and W&I, with the concurrence of the respective fraud enforcement advisor (FEA), are authorized to assess civil fraud penalties. To the contrary, employees in other functions and non-examination employees are generally not authorized to assess the civil fraud penalty. When fraud is identified by staff that are not examiners, the case must be discussed with the employee's manager and the FEA for referral consideration. See IRM 25.1.11, Campus Collection Fraud Procedures, and IRM 25.1.14, Campus Examination Fraud Procedures.
  - (11) In cases closed as unagreed with a civil fraud penalty, the report must include any alternative penalty positions that are applicable. Closing an unagreed case without including an explanation of the alternative penalty positions in the report may hamper the government's litigation because the basis for the alternative penalty positions may be unclear to either Appeals or Counsel.
  - (12) The examiner's report will reflect the civil fraud penalty under IRC 6663 or IRC 6651(f) as appropriate, and identify the adjustments attributable to fraud.
  - (13) Written supervisory approval of penalties under IRC 6751(b)(1) must be obtained timely. See IRM 20.1.1.2.3.1, Timing of Supervisory Approval.
  - (14) Determination of a civil fraud penalty is a shared responsibility of the examiner, the examiner's group manager, and the FEA.
  - (15) For additional information see IRM 25.1, Fraud Handbook.

20.1.5.16.3  
(04-22-2019)  
**Penalty Referral**

- (1) If an examiner determines affirmative acts (firm indications) of fraud/willfulness exist and criminal criteria are met, the examiner will discuss with his or her group manager and the FEA for referral to Criminal Investigation (CI). Referral guidelines to CI are listed in IRM 25.1.3, Criminal Referrals.
- (2) When an examiner and FEA determines that only the civil fraud penalty applies, a referral to CI is **not** required. See IRM 25.1.2, Recognizing and Developing Fraud, and IRM 25.1.6, Civil Fraud.

20.1.5.16.4  
(08-31-2021)  
**Civil and Criminal Fraud**

- (1) The major difference between civil and criminal fraud is the degree of proof required to establish fraud on the part of the taxpayer.
  - a. Criminal fraud requires sufficient evidence to prove guilt beyond a reasonable doubt.
  - b. Civil fraud requires clear and convincing evidence of fraud with intent to evade tax.

- (2) Due to the lower standard of proof in civil cases, the civil fraud penalty may be imposed upon a taxpayer who was not convicted of criminal tax evasion. If the taxpayer is convicted of criminal tax evasion under IRC 7201, Attempt to Evade or Defeat Tax, the civil fraud penalty should be asserted for the same tax year.
- (3) Criminal conviction does not mean the civil penalty will be automatically sustained.
- (4) Examiners and managers should be aware of collateral estoppel and the important distinction it can have in civil tax fraud penalty cases. Collateral estoppel is a legal doctrine that prevents a taxpayer, who has been previously convicted of criminal tax evasion under IRC 7201, from asserting a defense to the civil fraud penalty. See IRM 25.1.6.4, Collateral Estoppel.
- (5) In collateral estoppel circumstances where the taxpayer was convicted under IRC 7201, written supervisory approval of penalties must be approved timely. See IRM 20.1.5.2.3, Supervisory Approval of Penalties
- (6) Examiners should coordinate closely with the group manager, fraud enforcement advisor, and counsel on cases involving potential fraud.
- (7) **Restitution Based Assessments (RBA)** - The civil fraud penalty must be addressed in all RBA cases and must have counsel approval if the fraud penalty will NOT be asserted, since the taxpayer(s) have been convicted in Federal Court.

20.1.5.16.5  
(04-22-2019)  
**Penalty Calculation**

- (1) The civil fraud penalty is derived by multiplying the 75 percent penalty rate times the underpayment attributable to civil fraud.
- (2) If any part of an underpayment is due to civil fraud, then the entire underpayment shall be treated as attributable to civil fraud unless the taxpayer establishes (by a preponderance of the evidence) that such portion of the underpayment is not attributable to fraud. See IRC 6663(b). The examiner will make a good faith effort to objectively weigh the evidence provided and eliminate those items that are inaccurate but not fraudulent from the penalty calculation. See IRC 6663(b).
- (3) For a calculation example involving civil fraud when gross receipts cause an adjustment to self-employment tax with a related change in the income tax deduction allowed under IRC 164(f), see Exhibit 20.1.5-5.

20.1.5.16.6  
(04-22-2019)  
**Civil Fraud Development**

- (1) If it is determined that a case has indications of fraud but not yet met criminal criteria, Form 11661, Fraud Development Recommendation—Examination, must be prepared. See IRM 25.1.2, Recognizing and Developing Fraud, for procedures on developing and processing a civil fraud case.

20.1.5.16.7  
(04-22-2019)  
**Penalty Assessments and Abatements**

- (1) The examiner will compute the penalty and provide any special closing instructions for CCP on Form 3198 or Form 3198-A.
- (2) The total civil fraud penalty amount will be assessed to MF with TC 320 using one of the following:

- Form 5344, Examination Closing Record
- Form 5403, Appeals Closing Record
- Form 5599, TE/GE Examined Closing Record

(3) Under certain conditions the fraud penalty is assessed to the Non-Master File (NMF) with TC 320 using one of the following:

- Form 4720, Return of Certain Excise Taxes on Charities and Other Persons Under Chapters 41 and 42 of the IRC
- Form 5734, Non-Master File Assessment Voucher

(4) The Form 5734 will be processed with the tax return.

20.1.5.16.8  
(04-22-2019)  
**Penalty Relief**

(1) In general, no fraud penalty is imposed on any portion of an underpayment if it is shown (by a preponderance of the evidence) that it is not attributable to fraud.

(2) In the case of a joint return (married filing jointly), the fraud penalty will not apply to a spouse unless some part of the underpayment is due to fraud of such spouse. See IRC 6663(c).

20.1.5.17  
(08-31-2021)  
**IRC 6662A,  
Accuracy-Related  
Penalty on  
Understatements With  
Respect to Reportable  
Transactions**

(1) IRC 6662A generally imposes an accuracy-related penalty on any reportable transaction understatement. The penalty applies to the following:

- a. Any listed transaction (which is one category of reportable transactions); and
- b. Any other reportable transaction if a significant purpose of the transaction is the avoidance or evasion of federal income tax.

**Note:** The terms “reportable transaction” and “listed transaction” are defined in IRC 6707A(c).

(2) A reportable transaction understatement under IRC 6662A is not the same as an underpayment for purposes of the IRC 6662 accuracy-related penalties. The reportable transaction understatement is the sum of the following:

- a. The increase in taxable income that results from a difference between the proper tax treatment of the item related to the transaction and the taxpayer’s treatment of the item multiplied by the highest tax rate imposed by IRC 1, for individuals or IRC 11 for corporations, and
- b. The decrease, if any, in the aggregate amount of credits which results from the difference between the taxpayer’s treatment of an item related to the transaction and the proper treatment of the item. See IRM 20.1.5.17.2 for a calculation example.

(3) The IRC 6662A penalty is 20 percent of the reportable transaction understatement if properly disclosed, and 30 percent of the reportable transaction understatement if not properly disclosed. The disclosure requirements are explained in IRM 4.32.4.2, IRC 6011-Overview of Disclosure Requirements.

(4) In the case of a reportable transaction, the IRC 6662A penalty will not be imposed if the taxpayer does the following:

- a. Adequately disclosed its reportable transaction as required under IRC 6011 and the associated regulations, and

b. Meets other criteria set out in IRC 6664(d) to establish reasonable cause and good faith.

- (5) Special rules apply for a reportable transaction understatement under IRC 6662A for partnership adjustments under the centralized partnership audit regime. See IRM 20.1.5.19, Bipartisan Budget Act of 2015 - Penalties with Respect to Partnership Adjustments.

20.1.5.17.1  
(12-13-2016)  
**Adequate Disclosure  
and Rescission of IRC  
6707A Impact on IRC  
6662A**

- (1) A taxpayer is treated as meeting the disclosure requirements of IRC 6011 and the associated regulations if the Commissioner (or the Commissioner's delegate) rescinds the penalty under IRC 6707A. See IRM 4.32.4.9, IRC 6707A Penalty Rescission Consideration, and IRM 4.32.4.11, Continuation of the Income Tax Examination and IRC 6662A Considerations, for additional guidance.
- (2) IRC 6707A authorizes the Commissioner to rescind the imposition of the penalty with respect to reportable non-listed transactions if it would promote compliance with the tax laws and effective tax administration. The penalty cannot be rescinded with respect to a listed transaction.
- (3) The examiner should question the taxpayer or otherwise determine whether the taxpayer successfully sought rescission of an IRC 6707A penalty with respect to the reportable transaction at issue because such rescission could directly impact the application of IRC 6662A.
- (4) See IRM 4.32.4, IRC 6707A Penalty for Failure to Include Reportable Transaction Information With Return, for detailed guidance regarding IRC 6707A. If questions arise with regards to the abatement procedures for IRC 6707A (and not the criteria or procedures for processing a rescission request), see IRM 4.32.4.8, Abatement Procedures, for specific information on IRC 6707A penalty abatement.
- (5) Although IRM 4.32.4.9(19), IRC 6707A Penalty Rescission Consideration, states that the rescission determination is not reviewable by Appeals or by any court, a taxpayer may appeal the applicability of IRC 6707A (whether associated with a listed or non-listed reportable transaction) independent of a rescission request. See IRM 4.32.4.6, Timely Appeals Requests-Overview, for additional guidance. However, a taxpayer is deemed to have disclosed its reportable transaction for purposes of IRC 6662A only where the IRC 6707A penalty has been rescinded by the Commissioner and abatement of the IRC 6707A penalty for any other reason is not deemed adequate disclosure.

20.1.5.17.2  
(04-22-2019)  
**Penalty Calculation**

- (1) The reportable transaction understatement is defined in IRM 20.1.5.3.1.
- (2) The information below provides a calculation of a reportable transaction understatement using the following facts:
- Z participated in a reportable transaction that had a significant purpose of tax avoidance and generated a \$250,000 loss in tax year 2016.
  - Z properly disclosed the transaction.

Reference	Explanation
Amount: \$250,000	Increase in taxable income resulting from the difference between the proper tax treatment and the taxpayer's treatment of the loss attributable to the reportable transaction.
Percentage: 39 percent (21 percent for tax years beginning in 2018)	Highest corporate income tax rate imposed by IRC 11.
Credit: \$0	Decrease in aggregate amount of credits that results from the difference between the taxpayer's treatment of the reportable transaction and the proper tax treatment of that transaction.

Z's reportable transaction understatement is \$97,500. A 20 percent penalty applies because Z properly disclosed the transaction under 26 CFR 1.6011-4. Z's accuracy-related penalty on the reportable transaction understatement under IRC 6662A is \$19,500 (\$97,500 x 20 percent).

**Note:** Due to the definition of "reportable transaction understatement," the IRC 6662A penalty, unlike the IRC 6662 penalty, will apply even if there is no underpayment of tax on the taxpayer's return, as shown in the illustration above.

(3) If the taxpayer files an amended return after the IRS first contacts the taxpayer regarding an examination of the return or any other dates specified by the IRS, the tax treatment of an item on the amended return is not taken into account in determining the reportable transaction understatement.

### 20.1.5.17.3 (08-31-2021)

#### Coordination With Other Penalties

- (1) The IRC 6662A penalty does not apply to:
- Any portion of an understatement on which the fraud penalty (IRC 6663) is imposed, and
  - Any portion of an understatement on which accuracy-related penalties at the increased rates determined under IRC 6662(h) for gross valuation misstatements or under IRC 6662(i) for nondisclosed, noneconomic substance transactions are imposed.
- (2) If the IRC 6662A penalty is imposed, the penalty under IRC 6676, Erroneous Claim for Refund or Credit, cannot not be imposed as a primary position but should be developed as an alternative position where appropriate.
- (3) The understatement attributable to the IRC 6662A reportable transaction is included in the IRC 6662(d) understatement calculation. However, the reportable transaction understatement upon which the IRC 6662A penalty is asserted is **not** included in the amount of the understatement used to determine the underpayment upon which the 20 percent under IRC 6662(d) penalty is asserted. Consequently **two** understatement calculations must be performed. The example below illustrates the calculation of the IRC 6662(d) and IRC 6662A penalties when both are applicable.

**Example:** A and B, husband and wife, filed a joint federal income tax return for TY 2005. A and B reported taxable income of \$15,800 and a tax liability of \$1,644. A and B participated in a reportable transaction of which a significant purpose was the avoidance or evasion of federal income tax and was not disclosed pursuant to IRC 6011. A and B had no amounts previously assessed (or collected without assessment) and no rebates had been made. Subsequently, the return was examined and the taxpayers agreed to the adjustments and penalties as follow:

Description	Adjustments	Amount
Adjustment 1 (no penalty)		\$1,000
Adjustment 2 (subject to IRC 6662(d))		40,000
Adjustment 3 (subject to IRC 6663)		45,000
Adjustment 4 (subject to IRC 6662A)		34,000
Total adjustments		\$120,000
Taxable income shown on return		15,800
Taxable income as corrected		\$135,800
Tax as corrected		\$27,755
Taxable income as corrected excluding adjustment 4		\$101,800
Computation of underpayment of tax excluding the underpayment attributable to the reportable transaction understatement.		
Tax as corrected excluding tax attributable to reportable transaction		\$18,780
Tax shown on return	\$1,644	
Previous assessments	(\$0)	
Rebates	(\$0)	
Balance		<u>\$1,644</u>
Underpayment of tax excluding the underpayment attributable to the reportable transaction understatement		\$17,136
<b>Step 1:</b> Determine the portion, if any, of the underpayment on which no penalty is imposed.		
Taxable income as shown on return		\$15,800
Adjustment 1 (No penalty imposed)		<u>1,000</u>
“Adjusted” taxable income		\$16,800
Tax on “adjusted” taxable income		\$1,794
Tax shown on return		<u>\$1,644</u>
Portion of underpayment on which no penalty is imposed		\$150

Description	Adjustments	Amount
<b>Step 2:</b> Determine the portion, if any, of the underpayment on which a substantial understatement of income tax penalty of 20 percent is imposed.		
“Adjusted” taxable income from Step 1		\$16,800
Adjustment 2		<u>40,000</u>
“Adjusted” taxable income		\$56,800
Tax on “adjusted” taxable income		\$7,794
Tax on “adjusted” taxable income from Step 1		<u>1,794</u>
Portion of underpayment of tax on which 20 percent penalty is imposed		\$6,000
IRC 6662(d) penalty = \$1,200 (\$6,000 x 20 percent)		
<b>Step 3:</b> Determine the portion, if any, of the underpayment on which a fraud penalty of 75 percent is imposed.		
Total underpayment of tax		\$17,136
Less the sum of the portions of such underpayment determined in Step 1 and Step 2.		
Step 1	\$150	
Step 2	<u>6,000</u>	
Total		\$6,150
Portion of underpayment of tax on which 75 percent penalty is imposed		\$10,986
IRC 6663 penalty = \$8,240 (\$10,986 x 75 percent)		
<b>Step 4:</b> Determine the portion of the understatement of tax on which a 30 percent is imposed.		
Amount of increase in taxable income resulting from reportable transaction		\$34,000
Highest rate of tax imposed by IRC 1		35 percent
Reportable transaction understatement and portion of understatement on which 30 percent penalty is imposed		\$11,900
IRC 6662A penalty = \$3,570 (\$11,900 x 30 percent)		

**Note:** A and B’s tax required to be shown on the return with all adjustments included was \$27,755. To determine whether there was a substantial understatement, the understatement must exceed the greater of \$5,000 or 10 percent of the tax required to be shown on the return. In this example 10 percent of the tax required to be shown on the return is \$2,775. The reportable transaction understatement of \$11,900 is included in the total understatement.

A and B's understatement of tax subject to the penalty under IRC 6662(d) was \$6,000. As noted above, the \$11,900 reportable transaction understatement is added in calculating the amount of the understatement to determine whether it is substantial. The total of \$17,900 is substantial because it exceeds the greater of \$5,000 or \$2,775.

The 20 percent substantial understatement penalty under IRC 6662(d) will only be applied to the \$6,000 underpayment attributable to the understatement of tax resulting from the \$40,000 adjustment.

20.1.5.17.4  
(12-13-2016)  
**Penalty Assessments  
and Abatements**

- (1) IRC 6662A penalty is assessed on an examination report in the same manner as IRC 6662 penalties.
- (2) The examiner should determine whether the taxpayer successfully sought rescission of an IRC 6707A penalty with respect to the same transaction, as rescission may impact the application of the IRC 6662A penalty. See IRM 20.1.5.17.1.

**Reminder:** Since a rescission is not available for a listed transaction, rescission consideration does not apply to listed transactions.

- (3) Taxpayers are entitled to pre-assessment appeals consideration and statutory notice of deficiency procedures for the IRC 6662A penalty. When forwarding a case to Appeals, the examiner should ensure the IRC 6662A case file transmitted to Appeals through Technical Services includes an alternative penalty position and information, if available, on any prior Appeals decisions pertaining to this issue, including the appeals officer's name.
- (4) See IRM 20.1.5.4.2 for additional penalty assessment and abatement guidance.

20.1.5.17.5  
(12-13-2016)  
**Penalty Relief**

- (1) The IRC 6664(d) reasonable cause provision for the IRC 6662A penalty will not apply to any transaction lacking economic substance. See IRC 6664(d)(2).
- (2) The accuracy-related penalty under IRC 6662A does not apply with respect to any portion of a reportable transaction understatement if, pursuant to IRC 6664(d), it is shown that there was reasonable cause and the taxpayer acted in good faith with respect to that portion of the understatement. A taxpayer does not have reasonable cause and did not act in good faith unless:
  - a. The relevant facts affecting the tax treatment of the item are adequately disclosed in accordance with the regulations prescribed under IRC 6011 or the IRC 6707A penalty for failure to disclose is rescinded in full;
  - b. There is or was substantial authority for the treatment of the item; and
  - c. The taxpayer reasonably believed that its treatment of the item was more likely than not the proper treatment.

20.1.5.18  
(08-31-2021)  
**IRC 6676, Erroneous  
Claim for Refund or  
Credit Penalty**

- (1) The IRC 6676 penalty was enacted in the Small Business and Work Opportunity Tax Act of 2007 to complement and close a gap left by the following penalties which apply to underpayment of tax:
  - IRC 6662, Accuracy-Related Penalty
  - IRC 6662A, Accuracy-Related Penalty on Understatements with Respect to Reportable Transactions
  - IRC 6663, Fraud Penalty

- (2) IRC 6676 does not apply to any portion of the disallowed amount of the claim for refund or credit that is subject to the penalties listed above.
- (3) An IRC 6676 penalty may be imposed on a claim for refund or credit (filed after the enactment date of May 25, 2007) that arises from a taxpayer filing an original return, an amended return, claim, or any other form or writing that contends the taxpayer made an overpayment of tax for a particular tax year. The definition of a claim for refund or credit includes informal communications that would satisfy the jurisdictional requirement of IRC 7422(a), Civil Actions for Refunds, that the taxpayer file a claim for refund or credit before bringing a refund suit. If you are unsure whether an informal communication satisfies the jurisdictional requirement of IRC 7422(a), contact local counsel.
- (4) The IRC 6676 penalty applies when an “excessive amount” is determined, and for which there is no reasonable cause for the claimed tax treatment. (For claims filed before December 18, 2015 a reasonable basis standard should apply.)

**Note:** An examiner should consider a penalty against the preparer if warranted. See IRM 20.1.6, Preparer, Promoter, Material Advisor Penalties, for guidance.

- (5) **Excessive Amount** - The taxpayer filing the claim for credit or refund shall be liable for the penalty in the amount of 20 percent of the “excessive amount” claimed. IRC 6676(b) defines the “excessive amount” as the amount of the claim for refund or credit that exceeds the amount allowable for any taxable year.
- (6) Any excessive amount with respect to IRC 6662(b)(6), noneconomic substance transactions, shall be treated as lacking reasonable cause (reasonable basis if the claim is filed before December 18, 2015). See IRC 6676(c).
- (7) When an excessive amount of a refund claim is dependent on the determination of a deficiency, the IRC 6676 penalty on the excessive amount is subject to deficiency procedures. See IRM 20.1.5.18.4. This can occur in “frozen refund” situations where a taxpayer has claimed a refund on an original income tax return, but where the amount has not been refunded or credited to the taxpayer. The IRS has adopted the practice of treating the amount of the frozen refund as a sum collected without assessment for purposes of calculating the underpayment, with the result, in many cases, that there is no underpayment and therefore no penalty under IRC 6662 or 6663. In these situations, the excessive amount of the refund claim is part of a deficiency, and the IRC 6676 penalty is therefore subject to deficiency procedures.

**Example:** A taxpayer files an original return, claiming tax withholdings of \$1,000, and showing tax of \$500 on the return. The IRS determines that the taxpayer accurately reported her tax withholdings but that the amount of income tax imposed by the Code is \$1,000. The IRS freezes the \$500 refund claimed by the taxpayer. Because the IRS froze the refund, the amount of the underpayment is zero, calculated as follows:

$$\text{Underpayment} = W - (X + Y - Z)$$

$$W = \text{amount of income tax imposed} = \$1,000$$

$$X = \text{amount shown as the tax by the taxpayer on her return} = \$500$$

$$Y = \text{amounts not so shown previously assessed (or collected without assessment)} = \$500$$

Z = amount of rebates made = \$0

Underpayment = \$1,000 – (\$500 + \$500 – \$0) = \$0

Because there is no underpayment, no penalty may be imposed under IRC 6662 or 6663. But a penalty may be imposed under IRC 6676 on the \$500 excessive amount of the refund claim, if applicable. Because the \$500 excessive amount is part of a deficiency, the IRC 6676 penalty is also subject to deficiency procedures.

- (8) In all other cases where the excessive amount is not part of a deficiency, the IRC 6676 penalty is assessable without following deficiency procedures. See IRM 20.1.5.18.5.

**Example:** A taxpayer files an amended return claiming a refund in the amount of \$1,400. The IRS determines that there is an overpayment of only \$400; the IRC 6676 penalty will be computed at 20 percent of the “excessive amount” of \$1,000 and is assessable without following deficiency procedures. The IRC 6676 penalty is \$200 (\$1,000 x 20 percent).

- (9) **Meeting a Reasonable Cause Standard** - For claims filed on or after December 18, 2015 a reasonable cause standard applies. The reasonable cause exception for IRC 6676 penalty has the same general meaning as the reasonable cause exception found in IRC 6664(c), and 26 CFR 1.6664-4.
- a. Reasonable cause criteria is discussed in IRM 20.1.5.7.1
  - b. Refer to Exhibit 20.1.5-6, Determining Reasonable Cause and Good Faith, for examples of types of conduct that may or may not constitute reasonable cause.
- (10) **Reasonable Basis** - For claims filed before December 18, 2015 a reasonable basis standard applies. With respect to legal errors, “reasonable basis” has the same meaning in IRC 6676 as reasonable basis in 26 CFR 1.6662-3(b)(3) except that the reference to the reasonable cause and good faith exception in 26 CFR 1.6662-3(b)(3) does not apply to this section.
- (11) **Meeting a Reasonable Basis Standard** - A claim that is merely arguable or colorable will not meet the reasonable basis standard. A claim that a taxpayer reasonably bases on one or more of the authorities set forth in 26 CFR 1.6662-4(d)(3)(iii) will generally satisfy the reasonable basis standard. Any excessive amount that is attributable to a transaction lacking economic substance, or is otherwise described in IRC 6662(b)(6), shall not be treated as having a reasonable basis.
- (12) Generally, a claim that is without basis in fact, that is not supported by adequate books and records, or that cannot be substantiated will not satisfy the reasonable basis standard. An excessive claim resulting from an honest factual error that is reasonable in light of the facts and circumstances, however, such as an isolated computational or transcription error, is generally not inconsistent with reasonable basis.

**Example: #1** - C, a corporation, files a Form 1120-X, *Amended U.S. Corporation Income Tax Return*, and attaches an amended Form 3800, *General Business Credit*, claiming a credit under IRC 41 for increasing research activities. The amended return seeks a large refund based on the increased research activities credit. C’s claim for refund is denied and an

IRC 6676 penalty is asserted with respect to the excessive amount of the refund claim. C contends that it had a reasonable basis for claiming a refund based on the increased research activities credit. However, C is unable to provide any documentation demonstrating that, as a factual matter, it incurred the qualified research expenses for which the credit is being claimed. C's claim for refund does not have a reasonable basis.

**Example: #2** - O, an individual, timely filed Form 1040-X, Amended U.S. Individual Income Tax Return, showing a tax liability of zero and an additional child tax credit of \$1,500. O reported two qualifying children, for the purposes of the additional child tax credit, and reported that each of the children lived with O during the tax year. O claims as a refund the \$1,500 child tax credit. O's claim for refund is denied and an IRC 6676 penalty is asserted. O concedes that the children he claimed on the return were not his qualifying children and did not live with him in the United States at any point during the tax year. However, O says that he was advised by his return preparer that he could claim the child tax credit. Neither O nor the return preparer can identify any published legal authority set forth in 26 CFR 1.6662-4(d)(3)(iii) on which they relied in characterizing O's children as his qualifying children on the return. O's claim for refund does not have a reasonable basis.

**Example: #3** - T, an individual, timely files Form 1040, *U.S. Individual Income Tax Return*, showing a capital loss based on the bankruptcy of a company in which T had purchased stock. T later makes an amended return recharacterizing the loss as a theft loss. T claims a large refund which is denied, and an IRC 6676 penalty is asserted. T claims that her refund had a reasonable basis because she consulted her CPA about the theft loss issue and was advised that it was appropriate to recharacterize the capital loss as a theft loss. Neither T nor the CPA can identify any published legal authority set forth in 26 CFR 1.6662-4(d)(3)(iii) on which they relied in recharacterizing the capital loss as a theft loss. T's claim for refund does not have a reasonable basis.

**Example: #4** - D, an individual, timely files his Form 1040, *U.S. Individual Income Tax Return*, showing a capital loss based on the bankruptcy of a company in which D had purchased stock. D later makes an amended return substantially increasing the amount of capital loss. D claims a large refund. D's claim for refund is denied and an IRC 6676 penalty is asserted. D claims that his refund claim had a reasonable basis and submits substantiating documents and provides the legal authority on which he relied in calculating the increased capital loss he reported on the amended return. The materials submitted by D support his claim for an increased capital loss, but D made a mathematical error in calculating the amount of his refund and claimed a larger refund than the amount he is entitled to. D's claim for refund, although excessive, has a reasonable basis.

20.1.5.18.1  
(12-13-2016)

**Imposition of IRC 6676  
Penalty on Identity Theft  
Perpetrator**

- (1) An IRC 6676 penalty can be asserted against perpetrators of identity theft who, without authority, use a third party's identifying information to file a return(s) or claim(s) for refund or credit.

- (2) Identity theft occurs when someone uses an individual's personal information, such as name, social security number (SSN), or other identifying information without permission to commit fraud or other crimes.
- (3) Whether the IRC 6676 penalty applies to an identity theft perpetrator must be determined based on the specific facts and circumstances in the assigned identity theft case. Other penalties, including penalties under IRC 6694, IRC 6695, or IRC 6701, may more appropriately apply to the perpetrator. Field counsel may need to be contacted for assistance in determining the appropriate penalty for your identity theft case.
- (4) If an IRC 6676 penalty applies to an identity theft perpetrator, the penalty should be assessed against the taxpayer identification number (TIN) of the perpetrator. Use the procedures (without deficiency procedures) below in IRM 20.1.5.18.5.
- (5) If a perpetrator is believed to have filed multiple claims for refund or credit returns involving identity theft, a referral should be made to the SB/SE Lead Development Center for consideration of a promoter investigation. See IRM 4.32.2.4.2, SB/SE Lead Development Center (SB/SE LDC). Referrals to CI may also be warranted. See IRM 25.1.3, Criminal Referrals.
- (6) For additional information about working with identity theft victims, see IRM 25.23, Identity Protection & Victim Assistance.

20.1.5.18.2  
(04-22-2019)

**Statute Consideration**

- (1) To avoid uncertainty, the IRC 6676 penalty should be assessed within three years of the date when the claim for refund or credit was filed. The assessment statute expiration date (ASED) for assessment of an erroneous claims penalty can be extended using Form 872-EC, Consent to Extend the Time on Assessment of IRC section 6676 Erroneous Claim for Refund or Credit Penalty.

**Note:** The ASED for the income tax case and the IRC 6676 penalty could be different dates or the dates could be the same if the claim for refund is the original tax return. In any event, the ASED for assessment of a tax deficiency and the ASED for assessment of the IRC 6676 penalty should be separately controlled. Contact Division Counsel if you have questions about assessing the IRC 6676 penalty beyond the three-year period.

20.1.5.18.3  
(08-31-2021)

**Penalty Assertion**

- (1) IRC 6676 penalties apply to any form or document that presents a claim for refund or credit that has no reasonable cause (reasonable basis if filed before December 18, 2015). The forms to which the penalty could apply include, but are not limited to: Form 843, Form 1040 series, and Form 1120 series. This list is not all inclusive. It may be asserted during an examination or upon the disallowance of a claim.

**Note:** Although IRC 6676 does not apply to claims for refund or credit relating to the EITC filed on or before December 18, 2015, IRC 32(k), Restrictions on Taxpayers Who Improperly Claimed Credit in Prior Year, provides a 2 or 10 year ban on claiming EITC for reckless or fraudulent claims respectively.

- (2) When examining federal income tax returns, claims or amended tax returns, if there is a question as to whether there is a reasonable cause (reasonable basis if the claim was filed before December 18, 2015), the IRC 6676 penalty should be considered.
- (3) Generally, the penalty will not be proposed until the excessive amount is determined. See IRM 4.10.8.10, Claims.

20.1.5.18.3.1  
(12-13-2016)  
**Coordination With Other Penalties**

- (1) Pursuant to IRC 6676(d) the penalty shall not apply to any portion of the disallowed portion of the claim for refund or credit that is subject to one of the following:
  - a. Any component of IRC 6662
  - b. IRC 6662A
  - c. IRC 6663
- (2) The IRS can impose the IRC 6676 penalty in addition to other penalties, except those listed in (1) above, and can impose the penalty on multiple claims lacking reasonable cause (reasonable basis if the return is filed before December 18, 2015.) On a case by case basis, the IRS shall apply a rule of equity and good conscience to determine whether to impose the IRC 6676 penalty in addition to other penalties or on multiple claims.

20.1.5.18.4  
(04-22-2019)  
**Case Procedures WITH Deficiency Procedures**

- (1) The IRC 6676 penalty should be included on examination deficiency reports when determination of the IRC 6676 penalty is dependent on the determination of a deficiency. That will be the case only when the taxpayer makes an erroneous claim for refund or credit of a refundable credit and the refund is frozen. The disallowed refundable credit will result in a deficiency, but because the refund is frozen, there will be no underpayment. See IRM 20.1.5.18. This includes examination deficiency reports incorporated into AUR, RGS, and other IRS programs that generate deficiency reports.
- (2) In all other cases in which the IRC 6676 penalty is applicable, the penalty is not dependent on the existence of a deficiency and is therefore assessable without following deficiency procedures. See IRM 20.1.5.18.5.

20.1.5.18.4.1  
(08-31-2021)  
**Penalty Assertion**

- (1) The examiner will compute all return-related penalties in accordance with IRM 20.1.5.4 for CCP and include the penalties in the examination report.
- (2) The amount of the IRC 6676 penalty is 20 percent of the “excessive amount.”
- (3) No stacking of IRC 6662, IRC 6663, IRC 6662A, and IRC 6676 penalties is permitted.

**Reminder:** Although “stacking” of penalties is not permitted, other penalties should be developed and documented as alternative positions when appropriate. See IRM 20.1.5.4.

- (4) Written supervisory approval of the IRC 6676 penalty is required, as provided in IRC 6751(b)(1). Approval must be obtained prior to issuing any written communication of penalties to a taxpayer that offers the taxpayer an opportunity to sign an agreement, or consent to assessment or proposal of the penalty. See IRM 20.1.1.2.3.1, Timing of Supervisory Approval.

20.1.5.18.5  
(08-31-2021)  
**Case Procedures  
WITHOUT Deficiency  
Procedures**

- (1) Generally, penalties are assessable without deficiency procedures when they are not dependent upon the determination of a deficiency.
- (2) IRC 6676 penalties are generally assessable without deficiency procedures when an excessive amount of a claim for credit or refund arises from an item or transaction other than an erroneous refundable credit.
- (3) A separate IRC 6676 penalty case file or case files must be created. The penalty case files are referred to as the “related” cases. The income tax file or the claim file is the “key” case. See IRM 20.1.5.18.6 for guidance on “related” case files.
- (4) Special procedures apply when asserting the penalty on Married Filing Joint (MFJ) cases. See IRM 20.1.5.18.6.
- (5) Do not establish or control the IRC 6676 penalty cases on the Audit Information Management System (AIMS). For SB/SE and LB&I examiners, penalty cases are controlled on Examination Returns Control System (ERCS) only as a **related** case file. The examiner prepares a Form 5345–D for each penalty case. Managerial approval of Form 5345–D is required.

**Note:** The procedures involving Form 5345-D, Examination Request–ERCS (Examination Returns Control System) Users, do not apply to TE/GE.

- (6) TE/GE functions do not use ERCS. The five business units of TE/GE have their own processing functions. If the TE/GE examiner determines the penalty is warranted, group manager approval should be secured.
- (7) After securing supervisory approval, the examiner advises the taxpayer(s) of the opening of the IRC 6676 penalty case.
- (8) After consideration of all the facts and circumstances, if the examiner determines IRC 6676 penalties apply, then the examiner prepares Form 886-A, Explanation of Items, for each case.
- (9) Penalties requiring supervisory approval must be approved timely. See IRM 20.1.5.18.4.1(4) and IRM 20.1.1.2.3.1, Timing of Supervisory Approval, for policy regarding timing of supervisory approval. The immediate supervisor is required to sign line 11a and date line 11b of Form 8278, Assessment and Abatement of Miscellaneous Civil Penalties.
- (10) Written supervisory approval of the IRC 6676 penalty must be obtained prior to issuing Letter 4143-C and Form 5838-EC to the taxpayer. Examiners should complete the appropriate IRC 6676 penalty lead sheet and include it in the penalty case file. Any supervisory involvement must be documented in the case file.
- (11) The examiner explains the issue to the taxpayer and or representative and offers a meeting with the examiner’s manager to discuss the penalty issue.
- (12) If further discussion of the penalty results in non-assertion, the conversation should be documented in the penalty case file workpapers and the ERCS control closed. The **related** penalty case files can be associated with the claim for refund or credit “key” case and closed under normal claim procedures.
- (13) If further discussion of the penalty results in a determination that the penalty is warranted, the examiner prepares and issues Letter 4143-C, 30-Day Letter for

IRC Section 6676 Penalty. This letter advises the taxpayer of the proposed penalty, solicits payment, offers an Appeals conference, and provides an explanation of the dispute process. The examiner will include a copy of Form 5838-EC, Agreement to Assessment and Collection-Section 6676 Erroneous Claim for Refund or Credit Penalty; Form 886-A; and other pertinent documents and workpapers with the letter.

- (14) Do not prepare Form 4549. The IRC 6676 penalty should not be included on the examination report (30-day letter), or SNOD when the penalty is a non-deficiency penalty.
- (15) Associate the IRC 6676 “related” case file with the “key” income tax case (or claim for refund or credit) until it is resolved.
- (16) If the “key” case and the penalty case are not resolved with an agreement by the taxpayer, close the unagreed case files together as a package.
- (17) When claims are disallowed and the IRC 6676 penalty is not applicable, the examiner documents the basis for non-assertion of the IRC 6676 penalty in the “related” case file workpapers. A standard statement such as “Erroneous claims penalty deemed not applicable” **is not** sufficient. The reasons for applicability or non-applicability of the penalty must be clearly stated. The examiner’s manager should sign off on the decision not to apply the penalty when a substantial portion of the claim for refund or credit is disallowed.
- (18) Consult the group manager for assistance in developing the IRC 6676 penalty and evaluating a taxpayer’s reasonable cause (reasonable basis if the claim was filed before December 18, 2015) defense. Contact counsel if appropriate.
- (19) The examiner identifies the IRC 6676 penalty on Form 5838-EC and attaches a Form 886-A. The Form 886-A will clearly explain the IRC section, penalty name, and penalty computation.
- (20) The examiner’s time for the penalty case is applied to Activity Code 554.
- (21) If a paid tax return preparer prepared the claim for refund or credit return, it is the examiner’s responsibility to investigate and coordinate with his or her respective business unit’s return preparer coordinator (RPC) to ensure no return preparer violations exist. The Lead Sheet 300, Civil Penalty Approval Form has a preparer penalty section that should be completed to document that return preparer penalties were considered.

20.1.5.18.6  
(08-31-2021)  
**Non-deficiency  
“Related” Case File for  
Disallowed Claims**

- (1) Form 8278 is used for IRC 6676 penalty cases **except** for MFJ income tax return claims. The IRC 6676 penalty is assessed on **MFT 55 for IMF and MFT 13 for BMF with PRN 565** using Form 8278.
- (2) Form 3870, Request for Adjustment, is used when asserting the IRC 6676 penalty on MFJ income tax returns. The penalty “related” case for MFJ income tax return claims must be assessed on **MFT 30 with PRN 687. Do not use Form 8278 for MFJ penalty cases.**
- (3) Use the chart below for the correct penalty assessment form, MFT code and PRN.

<b>IMF returns (except MFJ)</b>	<b>IMF returns (MFJ only)</b>	<b>BMF returns</b>
Form 8278	Form 3870	Form 8278
MFT 55	MFT 30	MFT 13
PRN 565	PRN 687	PRN 565

- (4) The applicable “Special Handling Notice” is placed on the outside front cover of each case file.
- a. LB&I and SB/SE: The examiner completes Form 3198 by checking the “Civil Penalties (Form 8278)” box under “Special Features” or “Other” box with instruction “Civil Penalties” (Form 3870 or Form 8278 as appropriate).
  - b. TE/GE: The examiner completes Form 3198-A by entering similar information as indicated above for the “Special Features” section.
- (5) Included in the “related” penalty case file and placed in the location typical for the operating division are the following:
- a. Form 8278 or Form 3870 for MFJ taxpayers for each penalty tax year.
  - b. Form 9984, Examining Officer’s Activity Record.
  - c. Form 4318, Form 4318-OA, **or** Form 4700.
  - d. IRC 6676 penalty lead sheet (Penalty IRC 6676 Claim for Refund or Credit Lead Sheet).
  - e. Civil penalty approval form (e.g. Lead Sheet 300, Civil Penalty Approval Form, SAIN 011 Lead Sheet).
  - f. Form 5838-EC.
  - g. Form 886-A.
  - h. Copy of Letter 4143-C.
  - i. Taxpayer’s protest (response to Letter 4143-C), if applicable.
  - j. Examiner’s rebuttal to taxpayer’s protest, if applicable.
  - k. Copies of all correspondence to and from the taxpayer or taxpayer’s power of attorney relating to the erroneous claim or the IRC 6676 penalty.
  - l. Form 5345–D, ERCS users only (SB/SE and LB&I).
- (6) In the event that the “key” case file is closed separately from the “related” or penalty case file, the following information and documentation from the income tax case file should be placed in the “related” case file.
- a. Copy of the first four pages of the income tax return and any schedules related to income or expense items for which the erroneous claim for refund or credit was subsequently filed.
  - b. Copy of the original claim for refund or credit determined to be erroneous and lacking reasonable cause (reasonable basis if the claim was filed before December 18, 2015).
  - c. Copy of the portions of the income tax report relating to the partial or full disallowance of the excessive amount of the erroneous claim for refund or credit, including Form 886-A and supporting schedules.
  - d. Copy of forms and letters issued and/or secured relating to the partial or full disallowance of the erroneous claim, including, but not limited to Form 2297, Waiver of Statutory Notice of Claim Disallowance; Form 3363, Acceptance of Proposed Disallowance of Claim for Refund or Credit; and Letter 569, Full/Partial Preliminary Claim Disallowance Letter.

- e. Copy of reports from IRS engineers, economists, international specialists, outside fee experts, etc. relating to the erroneous claim for refund or credit.

**Note:** The examiner should make a copy of relevant documents from the penalty “related” case file to place in the penalty section of the income tax return examination case file (if applicable) and the claim for refund or credit “key” case file. This ensures documentation relating to IRC 6676 penalty will be available if the cases are processed and closed separately because of issues with the period of limitations for assessment.

20.1.5.18.7  
(12-13-2016)  
**Appeal Rights**

- (1) Pre-assessment Appeal rights procedures generally apply to IRC 6676 penalty cases not subject to deficiency procedures.
- (2) If the taxpayer timely requests Appeals consideration and provides a protest, the penalty case file will be updated to Status Code 21 and sent to Technical Services to be forwarded to Appeals in accordance with functional procedures. The IRS’s position should be clearly outlined with any alternative positions (if appropriate) prior to forwarding the case to Appeals. Appeals will contact the taxpayer to schedule an appointment.
- (3) Taxpayers may seek review of their liability for the IRC 6676 penalty in a United States District Court or the United States Court of Federal Claims. However, to seek court review of the liability for the IRC 6676 penalty, the taxpayer must first fully pay the liability and file a claim for refund with the IRS. Refund claims are usually filed on Form 843, Claim for Refund and Request for Abatement.

20.1.5.18.8  
(12-13-2016)  
**Group Processing and  
Penalty Assessment  
Instructions for IRC 6676  
Penalties Not Subject to  
Deficiency Procedures**

- (1) The IRC 6676 penalty case is not established or controlled on AIMS.
- (2) For SB/SE and LB&I cases, the group clerk or secretary inputs the IRC 6676 penalty “related” case on ERCS using information from the Form 5345–D completed by the examiner. Information unique for completing the Form 5345–D include the following:
  - a. Check box “Control Penalty Investigation.”
  - b. Activity Code 554 is used which automatically establishes MFT “PD” and Source Code 99.
  - c. The claim for refund or credit “key” case is also updated on ERCS.
  - d. The penalty case is the “related” case.
  - e. A statute date must be inserted. See IRM 20.1.5.18.2.
- (3) At the time of case closing, Form 3198 (SB/SE and LB&I) or Form 3198-A (TE/GE) will be completed by the examiner and affixed to the front of the case file.
  - a. Complete “Special Features” section noting that the case is “Civil Penalties (Form 8278)” or “Other” with instruction “Civil Penalties” (Form 3870 or Form 8278 as appropriate.)
  - b. The “related” IRC 6676 separate penalty case file should be associated with the “key” case file whenever possible.
  - c. Agreed penalty files along with the “key” case files are closed to CCP, Status Code 51 in accordance with functional procedures.
  - d. Appeal penalty cases are closed to Technical Services, Status Code 21, to be forwarded to Appeals.

**Note:** LB&I and SB/SE cases will use Disposal Code 12 for cases forwarded to Appeals.

- e. If the taxpayer does not request Appeals consideration or fails to respond, the penalty case file is closed for assessment of the penalty by updating to Status Code 51 and forwarding it to CCP in accordance with functional procedures.

(4) IRC 6676 penalty case is not subject to mandatory review.

20.1.5.18.9  
(04-22-2019)  
**Penalty Relief**

- (1) Reasonable cause criteria applies to an IRC 6676(a) penalty if the claim was filed on or after December 18, 2015 (reasonable basis for claims filed before December 18, 2015).
- (2) If a taxpayer entered into a transaction after March 30, 2010, any excessive amount that is attributable to a transaction described in IRC 6662(b)(6) will not be treated as having reasonable cause (reasonable basis if the claim was filed before December 18, 2015) under IRC 6676(c).

20.1.5.19  
(08-31-2021)  
**Bipartisan Budget Act of 2015 - Penalties with Respect to Partnership Adjustments**

- (1) Section 1101 of the Bipartisan Budget Act of 2015 (BBA), P.L. 114-74, repealed the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) partnership procedures and the electing large partnership provisions, and replaced them with a centralized partnership audit regime. The centralized partnership audit regime is effective for tax years beginning after December 31, 2017.
- (2) Section 1101(g)(4) of the BBA also provides that partnerships may “elect” to have the centralized partnership audit regime apply to partnership returns filed for tax years beginning after November 2, 2015 and before January 1, 2018. This election may only be made within 30 days of the date the IRS first notifies a partnership in writing that its return has been selected for examination.
- (3) Under IRC 6221(a), adjustments to partnership-related items (defined in 26 CFR 301.6241-1(a)(6)), are determined at the partnership level. The liability attributable to those adjustments is generally assessed and collected at the partnership level in the form of an imputed underpayment (determined under IRC 6225(b)(1), and 26 CFR 301.6225-1). The partnership may also be liable for penalties on the imputed underpayment (determined under IRC 6233).
- (4) A partnership may elect to push-out the adjustments determined at the partnership level under IRC 6226, in which case the tax and applicable penalties attributable to the adjustments is self-calculated and paid by the partnership’s partners. See IRM 20.1.5.19.4.

20.1.5.19.1  
(08-31-2021)  
**Imputed Underpayment (IU) - 26 CFR 301.6225-1(a)&(b)**

- (1) The imputed underpayment (IU) is the liability imposed on the partnership. It is generally computed by taking the total netted partnership adjustments for the reviewed year, multiplied by the highest rate of tax in effect for the reviewed year under IRC 1 or IRC 11, and increasing or decreasing the resulting product by the sum of net positive adjustments to creditable expenditure and credit groupings (and net negative adjustment to the credit grouping if appropriate).
- (2) The IU is calculated by segregating each partnership adjustment into one of four groupings:
- Reallocation grouping
  - Credit grouping

- Creditable expenditure grouping
- Residual grouping

If appropriate, the adjustments within each one of the groupings are further subgrouped and netted according to 26 CFR 301.6225-1, which will result in a net positive or net negative adjustment to those groupings and subgroupings.

- (3) Net positive adjustments in the credit grouping are added to the calculation of the IU after application of the tax rate to the total netted partnership adjustments. Net negative adjustments in the credit grouping are not to be included in the calculation unless the IRS determines it appropriate to include them. Decreases to creditable expenditures are to be treated as net positive adjustments in the credit grouping for purposes of the IU calculation. Increases to creditable expenditures are treated as net negative adjustments and are not to be included in the calculation of the IU.

**Note:** Refer to 26 CFR 301.6225-1(b)-(f), IRM 4.31.9, Centralized Partnership Audit Regime (BBA) Field Examination Procedures, and Interim Guidance LB&I-04-1019-010, for grouping, subgrouping of partnership adjustments, and netting rules to compute the IU.

- (4) The IU is assessed and collected in the same manner as a tax under Subtitle A of the Code, except deficiency procedures do not apply. See IRC 6232, and 26 CFR 301.6232-1.
- (5) A partnership making a push-out election is not liable for the IU. Instead, each reviewed year partner is liable for the tax, interest and penalties resulting from the partner taking into account its allocable share of adjustments to the partnership-related items. The partner is responsible for making and reporting these calculations.

20.1.5.19.2  
(08-31-2021)  
**Computation of  
Accuracy-Related and  
Fraud Penalties - 26 CFR  
301.6233(a)-1(c)(2)**

- (1) For purposes of computing accuracy-related and fraud penalties, the partnership is treated as an individual subject to tax under Chapter 1 of Subtitle A of the Code for the reviewed year. The IU is treated as the underpayment or understatement of tax for the reviewed year, and penalties are determined based on the IU.
- (2) The applicable penalties computed for the partnership's reviewed year should be reported on Form 14791, Form 14792, or Form 15027. The penalty code section and amount should be listed on the forms.
- (3) If the partnership elects push-out under IRC 6226, Form 8985, Pass-Through Statement-Transmittal/Partnership Adjustment Tracking Report, and Form 8986, Partner's Share of Adjustment(s) to Partnership-Related Item(s), will be used by the partnerships to furnish and transmit the adjustments and the applicability of any penalties to partnership-related items.
- (4) The applicability of any penalties, additions to tax, or additional amounts is determined at the partnership level. Penalties are paid by the partnership unless it elects to push out, then the penalties (if applicable based on the partner's facts and circumstances) are the liability of the partners. See IRM 20.1.5.19.4.

20.1.5.19.2.1  
(08-31-2021)

**Penalties Related to  
Imputed Underpayments**

- (1) Computing accuracy-related and fraud penalties requires a multi-step calculation to account for any negative adjustments using the ordering rules within each grouping or subgrouping determined under 26 CFR 301.6225-1.
  - a. A negative adjustment is any adjustment that is a decrease in an item of gain or income, an increase in item of loss or deduction, or an increase in an item of credit which includes an increase in a creditable expenditure.

**Note:** Refer to IRM 4.31.9, Centralized Partnership Audit Regime (BBA) Field Examination Procedures, and Interim Guidance LB&I-04-1019-010, for guidance in computing the IU under IRC 6225.
- (2) 26 CFR 301.6233(a)-1(c)(2) provides the rules for calculating penalties from the reviewed year under IRC 6662 and IRC 6663 related to the IU.
- (3) 26 CFR 301.6233(a)-1(c)(2)(iii) provides the rules for allocating negative adjustments:
  - a. If any grouping or subgrouping under 26 CFR 301.6225-1 contains a negative adjustment and at least one positive adjustment subject to penalty, the negative adjustment is first used to offset any positive adjustment to which no penalties have been imposed within that grouping or subgrouping. Adjustments that do not result in the IU (described in 26 CFR 301.6225-1(f)) and adjustments excluded from the determination of the IU (described in 26 CFR 301.6225-2(b)(2)) are disregarded for the purposes of computing penalties.
  - b. If any negative adjustments remain after offsetting positive adjustments where no penalties were imposed, the remaining negative adjustment is applied within the grouping or subgrouping against positive adjustments where a penalty has been imposed at the lowest rate. The process is repeated with respect to higher rates in ascending order of rate.
  - c. There are additional rules for negative credits. All adjustments to credits and adjustments treated as adjustments to credits are treated as grouped in the credit grouping without regard to whether the adjustments were subgrouped for purposes of 26 CFR 301.6225-1.

20.1.5.19.2.1.1  
(08-31-2021)

**Calculating the Portion  
of an Imputed  
Underpayment Subject  
to Penalty**

- (1) Negative adjustments are allocated to other adjustments in their grouping (or initially to their subgrouping, if applicable) in the following order:
  - a. Adjustments with respect to which no penalties have been imposed.
  - b. Adjustments with respect to which a penalty has been imposed at a 20 percent rate.
  - c. Adjustments with respect to which a penalty has been imposed at a 30 percent rate.
  - d. Adjustments with respect to which a penalty has been imposed at a 40 percent rate.
  - e. Adjustments with respect to which a penalty has been imposed at a 75 percent rate.
- (2) 26 CFR 301.6233(a)-1(c)(2)(ii)(A)-(F) provides six steps for calculating penalties after negative adjustments have been applied in accordance with 26 CFR 301.6233(a)-1(c)(2)(iii).

Action	Calculation
Step 1.	Total all adjustments subject to a particular penalty, except for adjustments to credits and creditable expenditures, at the highest rate of tax in effect for the reviewed year under IRC 1 or IRC 11 that was applied when calculating the IU. (26 CFR 301.6225-1(b)(1)(iv)).
Step 2.	Multiply the total in step 1 by the highest rate of tax in effect for the reviewed year under IRC 1 or IRC 11.
Step 3.	If the IU was modified under 26 CFR 301.6225-2(b)(3), repeat steps 1 and 2 for every tax rate applied in calculating the IU, by substituting the tax rate determined under 26 CFR 301.6225-2(b)(3) for the highest rate in effect for the reviewed year under IRC 1 or IRC 11.
Step 4.	Total amounts determined in steps 1 to 3.
Step 5.	26 CFR 301.6233(a)-1(c)(2)(ii)(E): Net all adjustments in the credit and creditable expenditure groupings. Increase step 4 by any remaining positive adjustments to credits or decrease by negative adjustments to credits in accordance with 26 CFR 301.6233(a)-1(c)(2)(iii)(C). Net negative adjustments to credits offset the portion of the IU to which no penalties apply, and then to the portion of the IU to which the lowest penalty applies, then to any portion of the IU subject to the next lowest penalty, unless the negative adjustments to credits are used up.
Step 6.	Multiply the total in step 5 by the penalty rate applicable to the particular penalty. This is the total penalty amount for adjustments to which the particular penalty was imposed.

(3) The following examples illustrate this section assuming the highest tax rate in effect for all taxpayers is 40 percent for all periods:

- The IRS made the following adjustments to a partnership 2018 partnership return:

**Example: #1 - One adjustment to which a penalty is imposed**

- \$100 positive adjustment to ordinary income, subject to a 20 percent negligence under IRC 6662(c)
- \$300 positive adjustment to long-term capital gain, no penalty applied

Action	Calculation
Step 1	\$100 (Portion of IU subject to penalty)
Step 2-3	\$100 x 40 percent (highest rate of tax) = \$40
Step 4	=\$40
Step 5	\$40 (IU to which penalty applies)
Step 6	IRC 6662(c) penalty =\$8 (\$40 x 20 percent)

**Example: #2 - More than one adjustment with the same rate of penalty**

- **The facts are the same in example 2, except there is a negative adjustment to ordinary income of \$50 that was subgrouped with the \$100 positive adjustment to ordinary income, and there is a positive adjustment to credits of \$10.**
  - a. \$100 positive adjustment to ordinary income, subject to a 20 percent negligence penalty under IRC 6662(c)
  - b. \$300 positive adjustment to long-term capital gain, no penalty applies
  - c. \$10 positive adjustment to credits, subject to 20 percent negligence penalty
  - d. \$50 negative adjustment to ordinary income, subgrouped with the \$100 adjustment to ordinary income

**Note:** Because the \$50 negative adjustment to ordinary income was subgrouped under 26 CFR 301.6225-1 with the \$100 positive adjustment to ordinary income, to determine the portion of the IU subject to penalty, the \$50 negative adjustment is applied to offset part of the \$100 positive adjustment to ordinary income.

Action	Calculation
Step 1	$\$100 - \$50 = \$50$ (Portion of IU subject to penalty)
Step 2-3	$\$50 \times 40$ percent (highest rate of tax) = \$20
Step 4	= \$20
Step 5	$\$20 + \$10 = \$30$ (IU to which penalty applies)
Step 6	IRC 6662(c) penalty = \$6 ( $\$30 \times 20$ percent)

**Example: #3 - Adjustment with different penalty rates**

- **The facts are the same in Example 3, except the \$300 long term capital gain adjustment is due to a gross valuation misstatement and subject to a 40 percent penalty:**
  - a. \$100 positive adjustment to ordinary income, subject to a 20 percent negligence penalty under IRC 6662(c)
  - b. \$300 positive adjustment to long-term capital gain, subject to a 40 percent gross valuation misstatement penalty under IRC 6662(h)
  - c. \$10 positive adjustment to credits, subject to 20 percent negligence
  - d. \$50 negative adjustment to ordinary income, subgrouped with the \$100 adjustment to ordinary income

Description	Action	Calculation
Adjustment 1	Step 1	$\$100 - \$50 = \$50$ (Portion of IU subject to 20 percent penalty)
	Step 2-4	$\$50 \times 40$ percent (highest rate of tax) = \$20
	Step 5	$\$20 + \$10 = \$30$ (IU to which 20 percent penalty applies)
	Step 6	IRC 6662(c) penalty = \$6 ( $\$30 \times 20$ percent)

Description	Action	Calculation
Adjustment 2	Step 1	\$300 (Portion of IU subject to 40 percent penalty)
	Step 2-5	\$300 x 40 percent = \$120 (IU to which 40 percent penalty applies)
	Step 6	IRC 6662(h) penalty = \$48 (\$120 x 40 percent)
Total Penalties		\$54

**Example: #4 - Modification of an IU.**

- **If the partnership modifies (IRC 6225(c)) the IU, the penalty is computed on the modified adjustments to which the penalty relates:**
  - a. Partnership has four equal partners during its 2019 taxable year: two partners are partnerships, A and B; one partner is a tax-exempt entity, C; and the fourth partner is an individual, D.
  - b. In an administrative proceeding with respect to Partnership's 2019 taxable year, the IRS timely mails a Notice of Proposed Partnership Adjustment (NOPPA) to Partnership for its 2019 taxable year proposing a single partnership positive adjustment to Partnership's ordinary income by \$400,000.
  - c. The \$400,000 positive adjustment is due to negligence or disregard of rules or regulations under IRC 6662(c). A 20 percent accuracy-related penalty under IRC 6662(a) & (c) applies to the portion of the IU attributable to the negligence or disregard of the rules or regulations.
  - d. In the NOPPA, the IRS determines an IU of \$160,000 (\$400,000 x 40 percent) and that the 20 percent applies to the entire IU.
  - e. The penalty due is \$32,000 (IU of \$160,000 x 20 percent penalty).
  - f. The partnership requests a modification under 26 CFR 301.6225-2(d)(3) (regarding tax exempt partners) with respect to the amount of additional income allocated to C, and also a modification under 26 CFR 301.6225-2(d)(2) (regarding amended returns) with respect to the additional income allocated to D, and the IRS approves the modification request.
  - g. As a result, Partnership's total netted partnership adjustment under 26 CFR 301.6225-1(b)(2) is \$200,000 (\$400,000 less \$200,000 allocable to C and D). The IU after modification is \$80,000 (\$200,000 x 40 percent), and the penalty is \$16,000 (\$80,000 x 20 percent).

20.1.5.19.3  
(08-31-2021)  
**Special Rules**

- (1) This section provides special rules outlined in 26 CFR 301.6233(a)-1(c)(2)(iv)(A)-(D)

20.1.5.19.3.1  
(08-31-2021)  
**Fraud Penalties Under IRC 6663**

- (1) If any part of an IU is attributable to fraud, the entire IU shall be treated as attributable to fraud unless the taxpayer establishes (by a preponderance of the evidence) that such portion of the underpayment is not attributable to fraud. See 26 CFR 301.6233(a)-1(c)(2)(iv)(A).
- a. The fraud penalty is derived by multiplying the 75 percent penalty rate times the IU attributable to fraud.

20.1.5.19.3.2  
(08-31-2021)

**Substantial Understatement Penalty Under IRC 6662(d)**

- (1) For purposes of Section 6662(d), the IU is treated as an understatement for purposes of calculating the substantial understatement penalty under IRC 6662(d)(2).
- (2) To determine whether the understatement is a substantial understatement for purposes of IRC 6662(d)(1), the amount of tax required to be shown on the return is the tax that would result by treating the net income or loss of the partnership for the reviewed year reflecting any partnership adjustments as taxable income described in IRC 1(c) (determined without regard to IRC 1(h)). See 26 CFR 301.6233(a)-1(c)(2)(iv)(B)(1).
- (3) Calculation of Substantial Understatement Penalty IRC 6662(d)(1), (As defined in 26 CFR 301.6233(a)-1(c)(2)(iv)(B)).

**Example:** For the 2018 reviewed year, the partnership reported net ordinary business loss of \$(500,000). IRS issued proposed partnership adjustments of \$1,200,000 and IU of \$444,000.

Calculation	Amount
Net Ordinary Loss	\$(500,000)
Partnership adjustments	\$1,200,000
Taxable income (26 CFR 301.6233(a)-1(c)(2)(iv)(B)(2)) - as described in IRC 1(c))	\$700,000
Amount of tax required to be shown on return (26 CFR 301.6233(a)-1(c)(2)(iv)(B)(2)) (\$700,000-\$500,000) x 37 percent + \$150,689.50	\$224,689.50
<b>To establish if understatement is substantial:</b>	
Understatement (IU defined in 26 CFR 301.6233(a)-1(c)(2)(iv)(B))	\$444,000
Amount of tax required to be shown on the return	\$224,689.50
Greater of \$5,000 or \$22,468.95 (IRC 6662(d)(1)(A) - greater of \$5,000 or 10 percent of tax required to be shown on return)	\$22,468.95
Substantial Understatement Penalty (\$444,000 x 20 percent)	\$88,800

**Note:** The understatement of \$444,000 exceeds \$22,468.95. The understatement is therefore substantial and penalty under IRC 6662(d) can be asserted.

**Note:** In calculating the amount of tax required to be shown on the return in the example above, the following apply:  
Tax rate per Rev. Proc. 2018-18 for the reviewed 2018 year: Table 3 - IRC 1(c) Unmarried individuals (other than surviving spouses and heads of households): \$150,689.50 plus 37 percent of the excess over \$500,000.  
The calculation of the amount of tax required to be shown on the return is based on the brackets and not using the highest rate as a flat rate. For the rate, it depends on what the tax rate is for individuals for the amount of taxable income calculated for the reviewed year.

20.1.5.19.3.3  
(08-31-2021)

**Reportable Transaction Understatement Under Section 6662A**

- (1) For purposes of IRC 6662A, the portion of the IU attributable to an item described under IRC 6662A(b)(2) is treated as a reportable transaction under-statement under IRC 6662A(b). See 26 CFR 301.6233(a)-1(c)(2)(iv)(C).

20.1.5.19.3.4  
(08-31-2021)

**Reasonable Cause and Good Faith**

- (1) In determining reasonable cause and good faith under IRC 6664(c) and 26 CFR 1.6664-4 for penalties asserted under IRC 6662, IRC 6663, and IRC 6662A, the partnership is treated as the taxpayer and only the facts and circumstances applicable to the partnership are considered. See 26 CFR 301.6233(a)-1(c)(2)(iv)(D).
- (2) There are no partner-level defenses to the assertion of penalties at the partnership level. See 26 CFR 301.6226-3(d)(3).
- (3) Partners can only challenge penalties with partner-level defenses by first paying the penalty and then filing a claim for refund for the reporting year.
- a. Partner-level defenses are limited to those that are personal to the reviewed year partner, (e.g., reasonable cause and good faith under IRC 6664(c)).

20.1.5.19.4  
(08-31-2021)

**Penalties in the Case of a Section 6226 Push-Out Election**

- (1) A partnership may elect the alternative to payment of imputed underpayment under IRC 6226. If a partnership makes a valid election to push-out the adjustments determined at the partnership level to its reviewed year partners, the reviewed year partners are liable for any penalties, additions to tax, or additional amounts on their share of the adjustments. See 26 CFR 301.6226-3(d).
- (2) If the reviewed year partner does not have an understatement after taking the partnerships adjustments into account, or has an understatement that falls below the applicable threshold for the imposition of a penalty, no penalty is due from that reviewed year partner. See 26 CFR 301.6226-3(d)(2).

**Note:** The reviewed year partners calculate the penalty using his/her own personal thresholds.

**Exhibit 20.1.5-1 (08-31-2021)**  
**Calculation of Underpayment Penalty**

Reference: IRM 20.1.5.3.2.

- a. The following example illustrates how an underpayment is computed:

Description	Amount
Corrected tax	\$10,000
<b>Less:</b> Tax per return	\$7,000
<b>Plus:</b> Any amounts not previously assessed or collected without assessment	0
<b>Plus:</b> Any amount of rebates made	0
Underpayment (\$10,000 less \$7,000)	\$3,000

- b. The following example illustrates a calculation of the underpayment with multiple adjustments:

Description	Amount	Computation of Underpayment
Adjustment A (no penalty imposed)	\$1,000	
Adjustment B (subject to 6662)	\$40,000	
Adjustment C (subject to 6663)	\$45,000	
Total adjustments (A + B + C)	\$86,000	
<b>Plus:</b> Taxable income shown on the return	\$15,800	
Taxable income as corrected	\$101,800	
Corrected tax		\$25,828
<b>Less:</b> Tax shown on return		\$2,374
<b>Less:</b> Previous assessments		0
<b>Less:</b> Rebates		0
<b>Underpayment</b>		<b>\$23,454</b>

- c. The following example illustrates the computation of the portions of the underpayment on which accuracy and fraud penalties are separately asserted:

Steps	Description	Amount
Determine the portion of the underpayment on which no accuracy-related or civil fraud penalty is imposed:		
<b>Step 1</b>	Taxable Income shown on return	\$15,800

## Exhibit 20.1.5-1 (Cont. 1) (08-31-2021)

## Calculation of Underpayment Penalty

Steps	Description	Amount
	<b>Plus:</b> Adjustment A (determined in example b)	\$1,000
	Adjusted taxable income	\$16,800
	Tax on adjusted taxable income	\$2,524
	<b>Less:</b> Tax shown on return	\$2,374
	<b>Portion of underpayment on which no penalty is imposed</b>	<b>\$150</b>
Determine the portion of the underpayment on which the accuracy-related penalty attributable to a substantial underpayment penalty under IRC 6662(d) of 20 percent is imposed:		
<b>Step 2</b>	Adjusted taxable income from Step 1	\$16,800
	<b>Plus:</b> Adjustment B (determined in example b)	\$40,000
	Adjusted taxable income	\$56,800
	Tax on adjusted taxable income	\$11,880
	<b>Less:</b> Tax on adjusted taxable income from Step 1	\$2,524
	<b>Portion of underpayment on which the 20 % penalty is imposed. IRC 6662(d) penalty = \$1,871 (\$9,356 x 20 percent)</b>	<b>\$9,356</b>
Determine the portion of the underpayment on which a civil fraud penalty (IRC 6663) of 75 percent is imposed:		
<b>Step 3</b>	Total underpayment (determined in example b)	\$23,454
	<b>Less:</b> The underpayment determined in Step 1	\$150
	<b>Less:</b> The underpayment determined in Step 2	\$9,356
	<b>Portion of underpayment on which the 75 percent penalty is imposed. IRC 6663 penalty = \$10,461 (\$13,948 x 75 percent)</b>	<b>\$13,948</b>

**Exhibit 20.1.5-2 (08-31-2021)****Calculation of the Accuracy-Related Penalty Attributable to a Substantial Understatement**

Reference:IRM 20.1.5.9.3

1. The amount of the IRC 6662(d) understatement is derived as follows: (A - (B - C) - D)

Description	Amount
(A) Corrected tax	\$8,500
(B) Less: tax on return	\$2,000
(C) Less: rebates	\$100
(D) Less: tax on adjustments with no penalty	\$600
Understatement	\$6,000

2. For the penalty to apply in the above example, the understatement of \$6,000 must be more than the greater of \$5,000 or \$850 (e.g., 10 percent of the \$8,500 corrected tax required to be shown on the return). The understatement of \$6,000 meets the requirement for penalty assertion.
3. In calculating the understatement in (2) above the following definitions apply:

**Rebates:** An amount not showing on the return which is assessed or collected as a deficiency prior to the filing of the return.

**Exceptions:** Substantial authority, adequate disclosure, and reasonable cause are exceptions to the penalty. See IRM 20.1.5.9.1.1 for discussion of substantial authority, and IRM 20.1.5.8.2.1, for adequate disclosure. Each return adjustment is reviewed separately to determine if any exceptions apply. When an exception applies to any adjustment, the tax on that adjustment is not used in determining the amount of the understatement or the amount of the underpayment to which the penalty applies.

4. To establish the amount of the penalty when not all adjustments are subject to the penalty:
- Calculate the total underpayment,
  - Calculate the underpayment subject to an exception,
  - Subtract (b) from (a), and
  - Multiply the applicable penalty rate times (c).
5. The following calculations establish if an understatement is substantial (no rebates or exceptions to the penalty apply):

**Example: (a) The taxpayer failed to report income of \$25,000 on his tax return:**

Computation	Amount
Corrected tax	\$20,000
<b>Less:</b> tax as reported on return	\$12,000
Understatement	\$8,000
Ten percent of corrected tax (10 percent of \$20,000 = \$2,000)	\$2,000

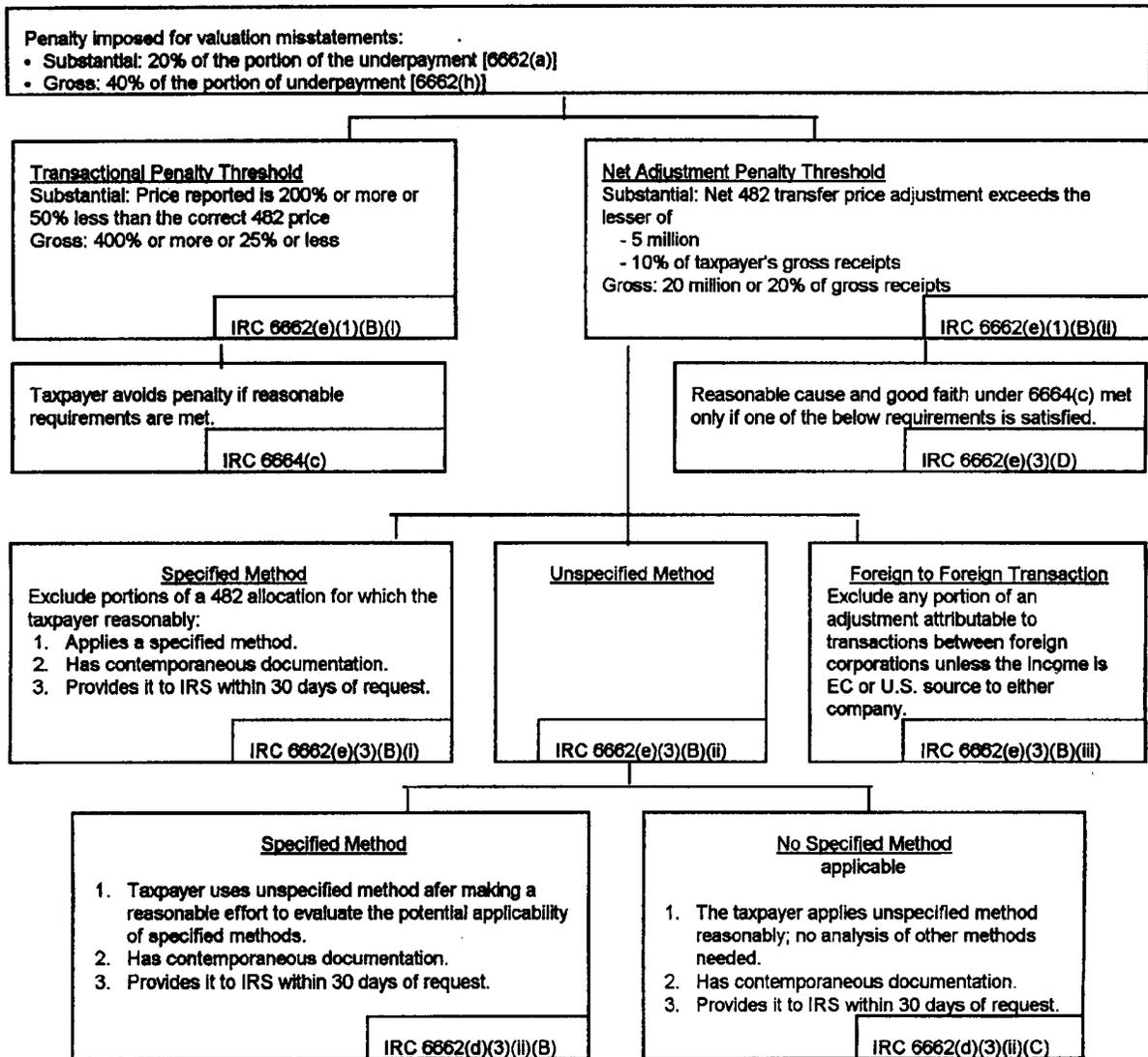
**Exhibit 20.1.5-2 (Cont. 1) (08-31-2021)****Calculation of the Accuracy-Related Penalty Attributable to a Substantial Understatement**

<b>Computation</b>	<b>Amount</b>
The greater of \$5,000 or \$2,000 <b>Note:</b> Since the \$8,000 understatement exceeds \$5,000, the understatement is substantial and meets the requirement for assertion under IRC 6662(d).	\$5,000

**Example: (b) The taxpayer failed to report \$247,000 of Schedule C income:**

<b>Computation</b>	<b>Amount</b>
Corrected tax (This includes any adjustment to self-employment tax)	\$67,000
<b>Less:</b> tax as reported on return	\$61,000
Understatement	\$6,000
The greater of \$5,000 or \$6,700 <b>Note: (1)</b> \$6,700 is 10 percent of corrected tax of \$67,000. <b>Note: (2)</b> The understatement of \$6,000 does not exceed the greater of \$5,000 or 10 percent of the corrected tax, e.g., \$6,700. The underpayment is therefore <b>not</b> substantial and the penalty cannot be asserted under IRC 6662(d) <b>Note: (3)</b> The accuracy-related penalty attributable to a substantial understatement will <b>not</b> be asserted on the same portion of the underpayment attributable to adjustments for which another accuracy-related penalty under IRC 6662 or the civil fraud penalty under IRC 6663 is asserted.	\$6,700

Exhibit 20.1.5-3 (10-01-2005)  
 IRC 6662(e), Transfer Pricing Penalty



Reference IRM 20.1.5.10.2.

**Exhibit 20.1.5-4 (08-31-2021)**  
**Substantial and Gross Valuation Misstatement Penalties**

Reference: IRM 20.1.5.12.2

The penalties are calculated on the amount of the underpayment attributable to each valuation understatement. The penalties are calculated as follows:

- a. The following adjustments and penalties apply:

Description	Amount
1. Stock A adjustment (no penalty applies) \$270,000 less \$200,000	\$70,000
2. Stock B adjustment (substantial valuation misstatement penalty applies) \$190,000 less \$80,000	\$110,000
3. Stock C adjustment (gross valuation misstatement penalty) \$330,000 less \$80,000	\$250,000

- b. Calculation of the underpayment for adjustments on which no penalty is applicable:

Description	Amount
1. Taxable income as filed	\$1,200,000
2. Adjustment without penalty	\$70,000
3. Adjusted taxable amount (line 1 plus line 2)	\$1,270,000
4. Tax on line 3	\$707,000
5. Tax on return	\$675,000
6. Underpayment attributable to \$70,000 adjustment	\$32,000

- c. Calculation of the underpayment for a substantial valuation misstatement penalty:

Description	Amount
1. Adjusted taxable amount from line (b)(3)	\$1,270,000
2. Adjustment having substantial valuation misstatement penalty	\$110,000
3. Adjusted taxable amount (line 1 plus line 2)	\$1,380,000
4. Tax on line 3	\$757,000
5. Amount from line (b)(4)	\$707,000
6. Underpayment attributable to \$110,000 (line 4 less 5)	\$50,000
7. Substantial valuation misstatement penalty (20 percent of \$50,000)	\$10,000

- d. Calculation of underpayment for a gross valuation misstatement penalty

**Exhibit 20.1.5-4 (Cont. 1) (08-31-2021)****Substantial and Gross Valuation Misstatement Penalties**

<b>Description</b>	<b>Amount</b>
1. Amount from (c)(3)	\$1,380,000
2. Adjustment having gross valuation misstatement penalty	\$250,000
3. Adjusted taxable amount (line 1 plus 2)	\$1,630,000
4. Tax on line 3	\$869,000
5. Amount from line (c)(4)	\$757,000
6. Underpayment attributable to \$250,000 (line 4 less 5)	\$112,000
7. Gross Valuation Misstatement Penalty (40 percent × \$112,000)	\$44,800

**Exhibit 20.1.5-5 (08-31-2021)****Calculation of the Underpayment Amount Attributable to Fraud Based on Self-Employment Tax Adjustment**

Reference: IRM 20.1.5.16.5

<b>Calculation of the Adjusted Taxable Income</b>	<b>Amount</b>
Unreported Schedule C gross receipts subject to fraud penalty	\$50,000
<b>Plus:</b> Taxable income shown on the return	\$70,000
<b>Less:</b> One-half of self-employment (\$3,000 less \$1,500)	\$1,500
Adjusted taxable income	\$118,500
Tax on adjusted taxable income	\$34,900
<b>Less:</b> Tax per return	\$15,000
<b>Plus:</b> Self-employment tax increase	\$3,000
Underpayment subject to fraud	\$22,900

**Exhibit 20.1.5-6 (12-13-2016)****Determining Reasonable Cause and Good Faith**

Reference IRM 20.1.5.7.1.

To determine reasonable cause and good faith take into consideration the taxpayer's effort to assert the proper tax liability.

Taxpayers are required to exercise ordinary business care and prudence, e.g., taking that degree of care that a reasonable prudent person would exercise. Below are some circumstances that may or may not indicate reasonable cause and good faith.

<b>Circumstances that may indicate reasonable cause and good faith:</b>	<b>Circumstances that may not indicate reasonable cause and good faith:</b>
Honest misunderstanding of fact or law that is reasonable given the experience, knowledge, sophistication and education of taxpayer.	Lack of significant business purpose.
An isolated computational or transcription error.	Reliance on advice of a tax advisor or appraiser who the taxpayer knows or should have known lacked sufficient expertise or lacked independence.
Reliance on erroneous information reported on Forms W-2, 1099, etc., provided that the taxpayer did not know or have reason to know that the information was incorrect.	Taxpayer agreed with the organizer or promoter of the tax shelter that the taxpayer would protect the confidentiality of the tax aspects of the structure of the tax shelter.
Reliance on advice of a tax advisor or appraiser who does not suffer from a conflict of interest or lack of expertise.	Claimed tax benefits are unreasonable in comparison to the taxpayer's investment in the tax shelter.
Reliance on erroneous information (e.g. cost or adjusted basis of property, or amount of opening or closing inventory) inadvertently included in data furnished by a corporation with multiple divisions or in financial books and records prepared by those divisions, provided the corporation employs internal controls or procedures aimed at identifying such factual errors.	Nondisclosure of a reportable transaction.

**Exhibit 20.1.5-7 (01-24-2012)**  
**Substantial Authority List**

Reference IRM 20.1.5.9.1.1.

There is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. 26 CFR 1.6662-4(d)(3)(i). The weight accorded an authority depends on its relevance, persuasiveness and the type of document providing the authority. 26 CFR 1.6662-4(d)(3)(ii).

Except in cases described in 26 CFR 1.6662-4(d)(3)(iv) concerning written determinations, only the following are authority for purposes of determining whether there is substantial authority for the tax treatment of an item:

- Applicable provisions of the IRC sections and other statutory provisions.
- Proposed, temporary, and final regulations construing such statutes.
- Revenue rulings and revenue procedures.
- Tax treaties and regulations thereunder and Treasury Department and other official explanations of such treaties.
- Court cases.
- Congressional intent as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, and floor statements made prior to enactment by one of a bill's managers.
- General explanations of tax legislation prepared by the Joint Committee on Taxation (the Blue Book).
- Private letter rulings and technical advice memoranda.
- Actions on decisions and general Counsel memoranda.
- IRS information or press releases.
- Notices, announcements and other administrative pronouncements published by the IRS in the Internal Revenue Bulletin.

Conclusions reached in treatises, legal periodicals, legal opinions, or opinions rendered by tax professionals are **not** authority. The authorities underlying such expressions of opinion where applicable to the facts of a particular case, however, may give rise to substantial authority for the tax treatment of an item.

There also is substantial authority if the treatment of an item is supported by one of the following:

- The conclusion of a ruling or a determination letter issued to the taxpayer.
- The conclusion of a technical advice memorandum in which the taxpayer is named.
- An affirmative statement in a revenue agent's report with respect to a prior taxable year of the taxpayer.

Such a written determination does not, however, demonstrate substantial authority if there was a misstatement or omission of a material fact or the facts that subsequently develop are materially different from the facts on which the written determination was based or if the written determination is modified or revoked after the date of issuance. See 26 CFR 1.6662-4(d)(3)(iv)(A).

**Exhibit 20.1.5-8 (08-31-2021)****Calculation of an Underpayment Involving Frozen Refunds**

Taxpayer filed a return reporting false income and tax withholdings and claiming a \$5,000 refund. The IRS did not process the return or issue a refund to Taxpayer. The IRS determined the following:

Description	Amount
Income tax imposed	\$1,000
Tax liability shown on the return	\$5,000
Withholdings claimed on return	\$10,000
Amount of tax actually withheld	\$1,000
Amount of rebates made	\$0

The underpayment is calculated as follows:

- $W = \text{amount of income tax imposed} = \$1,000$

This amount is determined without regard to credits for tax withholdings under sections 31 and 33, payments of tax or estimated tax, collection of any amounts assessed as the result of a termination or jeopardy assessment, and any tax the taxpayer is not required to assess on the return

- $X = \text{amount shown as the tax by the taxpayer on the return} = -\$4,000$

This amount is the tax liability shown by the taxpayer on the return determined without regard to credits for tax withholdings under sections 31 and 33, payments of tax or estimated tax, collection of any amounts assessed as the result of a termination or jeopardy assessment, except that it is reduced by the excess of the amounts shown by the taxpayer on the return as credits for tax withholdings under sections 31 and 33, payments of estimated tax, or as any other payments made by the taxpayer before filing the return over the amounts actually withheld or actually paid.

Tax liability shown on the return = \$5,000

Amounts shown as tax withholdings on return = \$10,000

Amount of tax actually withheld = \$1,000

$X = \$5,000 - (\$10,000 - \$1,000) = -\$4,000$

- $Y = \text{amounts not so shown previously assessed (or collected without assessment)}$

There is no amount previously assessed in this case.

The amount collected without assessment is the amount by which the total of the credits for tax withholdings under sections 31 and 33, estimated tax payments, and other payments made before the returns is filed exceed the tax shown on the return (provided such excess has not been refunded or allowed as a credit to the taxpayer).

**Exhibit 20.1.5-8 (Cont. 1) (08-31-2021)****Calculation of an Underpayment Involving Frozen Refunds**

Amount of tax withheld = \$1,000

Tax shown on the return = -\$4,000

Amount refunded or credited = \$0

$Y = \$1,000 - (-\$4,000) = \$5,000$

- $Z = \text{amount of rebates made} = \$0$

$\text{Underpayment} = W - (X + Y - Z) = \$1,000 - (-\$4,000 + \$5,000 - \$0) = \$0$