



OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE SERVICE CENTER ADVICE
MEMORANDUM FOR DISTRICT COUNSEL,

FROM: Acting Assistant Chief Counsel (Income Tax & Accounting)
SUBJECT: Significant Service Center Advice

This responds to your request for Significant Advice dated July 2, 1999, in connection with a request for guidance by the Austin Service Center. The Austin Service Center had the following issues with respect to when it is appropriate to make an assessment for the addition to tax under § 6651(a)(2) of the Internal Revenue Code if Part IV credits as shown on a return are subsequently reduced by the Service.

ISSUES

1. How should reductions to Part IV credits be treated for purposes of computing the addition to tax under § 6651(a)(2) (penalty for failure to pay tax shown on return)?
2. Should reductions to all Part IV credits that are part of the § 6211 deficiency calculations be treated the same for purposes of computing the § 6651(a)(2) penalty?
3. Should reductions to refundable credits be treated differently than reductions to non-refundable credits for purposes of computing the § 6651(a)(2) penalty?
4. When is it appropriate to increase the § 6651(a)(2) penalty if the penalty was previously computed for not paying an amount shown as tax on the return?

CONCLUSIONS

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1. Only reductions to §§ 31 and 33 credits, for withholding taxes, cause an increase to the § 6651(a)(2) penalty. Reductions to all other Part IV credits do not affect the § 6651(a)(2) penalty.

2. Reductions to Part IV credits which are part of § 6211 deficiency calculations do not cause an increase to the § 6651(a)(2) penalty. Generally, the addition to tax under § 6651(a)(3) (penalty for failure to pay tax required to be shown on return) will be applicable for adjustments to such Part IV credits.

3. Only reductions to refundable credits under §§ 31 and 33 of the Code cause an increase to the § 6651(a)(2) penalty. Non-refundable credits do not affect the § 6651(a)(2) penalty.

4. An increase to the § 6651(a)(2) penalty, caused by a reduction to a § 31 credit or a § 33 credit, should be made (assessed) at the same time the adjustment is made to the § 31 credit or § 33 credit.

FACTS

The issues arise from the apparent inconsistent treatment of reductions to Part IV credits by the Service for purposes of applying the § 6651(a)(2) penalty. Currently the Service treats reductions to refundable credits (§§ 31, 32, 33, and 34) as not changing the “amount shown as tax” on a return, but as a reduction to payments towards the total tax. Thus, the Service imposes the § 6651(a)(2) penalty when a reduction of a refundable Part IV credit occurs, since this is viewed as a reduction to the amount of tax paid. Conversely, the Service treats reductions to non-refundable credits as changing the “amount shown as tax” on a return. Thus, the Service does not impose the § 6651(a)(2) penalty when a reduction of a non-refundable Part IV credit occurs.

Although the Service treats §§ 31, 32, 33, and 34 credits similarly for purposes of the § 6651(a)(2) penalty, the credits under §§ 32 and 34 are part of § 6211 deficiency calculations. However, the credits under §§ 31 and 33 are not.

The following examples from your memorandum demonstrate how the Service currently applies reductions to part IV credits for purposes of the § 6651(a)(2) penalty.

Example 1 (Your example 1)

The taxpayer timely files a 1998 Federal income tax return reporting \$1000.00 of total tax and an earned income credit under § 32 of \$1000.00. This results in an overpayment / underpayment of \$0.00. It is later determined that the

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correct earned income credit is \$900.00. This results in a deficiency, as defined under § 6211, of \$100.00.

Total Tax Shown on Return	\$1000.00	
Payments Shown on Return:		
Earned Income Credit	<u>\$1000.00</u>	
Tax Liability		\$ 0.00
Correct Total Tax	\$1000.00	
Correct Payments:		
Earned Income Credit	<u>\$ 900.00</u>	
Correct Tax Liability		<u>\$ 100.00</u>
Deficiency		\$ 100.00

In this situation, the Service Center computes and assesses the § 6651(a)(2) penalty for failure to pay the tax shown on the return on the \$100 amount of the unpaid tax. As we understand it, the reason the Service Center imposes the penalty in this situation is because \$100.00 of the total tax shown on the return remains unpaid.

Example 2 (Your example 4)

The taxpayer timely files a 1998 return reporting a total tax of \$0.00 and an earned income credit under § 32 of \$100.00. The correct tax liability is \$0.00, but the correct earned income credit is \$0.00.

Total Tax Shown on Return	\$ 0.00	
Payments Shown on Return:		
Earned Income Credit	<u>\$100.00</u>	
Tax Liability (overpayment)		\$100.00
Correct Total Tax	\$ 0.00	
Correct Payments		
Earned Income Credit	<u>\$ 0.00</u>	
Correct Tax Liability		<u>\$ 0.00</u>
Deficiency		\$100.00

In this situation, the Service Center does not assess the § 6651(a)(2) penalty since there has not been a failure to pay the tax shown on the return.

Example 3 (your example 3)

The taxpayer timely files a 1998 return reporting total tax of \$100.00 and payments for income tax withheld on wages of \$100.00. The income tax liability is correct, but the correct withholding under § 31 is \$0.00.

Total Tax Shown on Return	\$ 100.00
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Payments Shown on Return:

Withholding	\$ 100.00	
Tax Liability		\$ 0.00

Correct Total Tax	\$ 100.00	
Correct Payments:		
Withholding	\$ 0.00	
Correct Tax Liability		\$ 100.00
Deficiency		\$ 100.00

In this situation, the Service Center computes and assesses the § 6651(a)(2) penalty for the taxpayer's failure to pay the amount of tax shown on the return. Example 3 is similar to example 1, because \$100.00 of the amount of tax shown on the return remains unpaid.

Example 4 (your example 2)

The taxpayer timely files a 1998 return reporting \$0.00 of total tax, because of a business credit under § 38 of \$1000.00. It is later determined that the correct business credit is \$0.00. This results in a deficiency, as defined under § 6211, of \$1000.00.

Total Tax Shown on Return	\$ 0.00	
Payments Shown on Return:	\$ 0.00	
Tax Liability		\$ 0.00
Correct Total Tax	\$1000.00	
Correct Payments:		
Withholding	\$ 0.00	
Correct Tax Liability		\$ 1000.00
Deficiency		\$ 1000.00

In this situation, the Service Center does not compute or assess the § 6651(a)(2) penalty since there has not been a failure to pay the tax shown on the return.

LAW

Section 6651(a)(2) of the Code imposes a penalty for failure to pay the amount shown as tax on the return on or before the date prescribed for payment of such tax (determined with regard to any extension of time for payment), unless it is shown that such failure is due to reasonable cause and not due to willful neglect.

Section 6651(a)(3) of the Code imposes a penalty for failure to pay the amount of tax required to be shown on a return which is not so shown within 21 calendar days from the date of notice and demand (10 business days if the amount for which the notice and demand is made equals or exceeds \$100,000), unless it is shown that such failure is due to reasonable cause and not due to willful neglect.

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Section 6651(b)(2) of the Code provides that for purposes of calculating the penalty under § 6651(a)(2) for any month, the amount of tax shown on the return will be reduced by the amount of any part of the tax which is paid on or before the beginning of the month and by the amount of any credit against the tax which may be claimed on the return.

Section 6211(a) of the Code provides that in the case of income, estate, and certain gift and excise taxes, the term “deficiency” means the amount by which the tax imposed exceeds the excess of (1) the sum of the amount of tax shown on the taxpayer’s return, plus the amount previously assessed (or collected without assessment) as a deficiency, over (2) the amount of any rebates.

Section 6211(b) of the Code specifically excludes from the deficiency calculations the credits under § 31 (tax withheld on wages) and § 33 (tax withheld at source on nonresident aliens and foreign corporations). Not excluded from the deficiency calculations are the credits under § 32 (earned income credit) and § 34 (certain uses of gasoline and special fuels).

DISCUSSION

In determining applicability of the § 6651(a)(2) penalty, the Service appears to treat adjustments to Part IV credits as described above for the following reasons. For purposes of the Form 1040, U.S. Individual Income Tax Return, the “amount shown as tax on the return” is the amount of **total tax** as shown on the line immediately above the payments section (Line 56 on 1998 Form 1040). Section 31, 32, 33, 34 credits are considered “below the line” credits because they are all applied after the calculation of total tax (below line 56 on 1998 Form 1040). These credits are treated like payments of tax. All other credits are included in the calculation of the total tax and are considered “above the line” credits (above line 56 on 1998 Form 1040). Below the line credits are refundable credits and above the line credits are non-refundable credits.

As stated above, reductions to non-refundable credits directly affect the calculation of the total tax, whereas reductions to refundable credits do not. Since the § 6651(a)(2) penalty is only applicable to the failure to pay tax as shown on the return, reductions to non-refundable credits would not trigger the § 6651(a)(2) penalty. However, reductions of refundable credits do not affect the tax shown on the return, but are treated like payments. A reduction to a refundable credit would trigger an increase to the § 6651(a)(2) penalty because there has been a failure to pay the amount of tax shown on the return.

Although the Service apparently follows the format of the Form 1040 to determine when subsequent reductions to Part IV credits should result in a § 6651(a)(2) penalty, we believe that applying the definition in § 6211 for a deficiency provides a better result than distinguishing refundable from non-refundable credits or above the line from below the line credits.

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As stated above a deficiency is defined in § 6211(a) as the amount of tax imposed that exceeds the amount of tax shown on the return. Therefore, if there is a deficiency on a taxpayer's return, this amount is an adjustment to the amount of tax shown on the return. Section 32 and 34 credits are specifically included as part of the calculation of a deficiency and cannot be reduced without following the deficiency procedures. See § 6211(b)(4). Thus, adjustments to credits that are considered in the calculations of a deficiency, here the reductions to credits under §§ 32 and 34, are by definition adjustments to the amount of tax shown on the return. When an amount of tax owed (i.e. a deficiency) is not the result of an adjustment to the amount of tax shown on the return, it cannot be included in the calculation of the penalty under § 6651(a)(2). Because, for purposes of § 6211(a), §§ 32 and 34 credits affect the amount of tax shown on the return, adjustments to these credits cannot trigger the § 6651(a)(2) penalty. The penalty under § 6651(a)(3) is applicable for failure to pay any resulting deficiency amounts.

Section 31 and 33 credits are specifically excluded as part of the calculation of a deficiency. See § 6211(a)(1). Thus, only subsequent adjustments to the credits under §§ 31 and 33 cause the § 6651(a)(2) penalty to be applicable. For purposes of § 6211(a), these credits are the only credits that do not affect the tax shown on the return.

Applying this analysis, we believe that examples two, three, and four are correct, but example one is incorrect. The reduction of the credit in example one is incorrect because the earned income credit under § 32 is subject to the § 6211 deficiency calculation and the penalty under § 6651(a)(2) does not apply when an increase in tax liability is related to a reduction of that credit.

In conclusion, the Service must discontinue its current practice of imposing the penalty under § 6651(a)(2) of the Code for reductions to the credits under § 32 (earned income credit) and § 34 (certain uses of gasoline and special fuels credit). The Service must only treat reductions to credits under § 31 (tax withheld on wages credit) and § 33 (tax withheld at source on nonresident aliens and foreign corporations credit) as imposing or increasing the amount of the penalty under § 6651(a)(2). The Office of Interest and Penalty Administration will also be so advised.

If you have any questions or concerns regarding this response, please contact Brad Taylor at (202) 622-4940.

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By: JUDITH M WALL
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