



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE TECHNICAL ADVICE

MEMORANDUM FOR TINA K. BYRD
MANAGER, INTERNATIONAL TECHNICAL ADVISORS
LMSB:PFT:IFASP

FROM: Elizabeth G. Beck, Senior Technical Reviewer, Branch 6

SUBJECT: I.R.C. §§ 6662(e)(1)(B) and 6662(h)

This memorandum responds to your request for Technical Assistance dated October 7, 1999. Technical Assistance does not relate to a specific case or taxpayer and is not binding on Examination or Appeals. This document is not to be used or cited as precedent.

ISSUES

Your request for Technical Assistance raises several questions regarding how the substantial and gross valuation misstatement penalties under section 6662(b)(3) and described in sections 6662(e)(1)(B) and 6662(h) (hereinafter the "Penalties," unless otherwise specified) are calculated. Specifically, you asked how to calculate the Penalties when (1) current year adjustments, including a section 482 adjustment to which the Penalties apply, overcome a current year loss; (2) current year adjustments, including a section 482 adjustment to which the Penalties apply, do not overcome a current year loss; and (3) current year income (as adjusted, including a section 482 adjustment to which the Penalties apply) is overcome by a net operating loss ("NOL") carryforward or carryback. The fourth question you asked is whether Treas. Reg. § 1.6662-6 applies exclusively when calculating the Penalties, or whether other regulations promulgated under sections 6662 and 6664 apply.

LAW AND ANALYSIS

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Relevant Statutory and Regulatory Provisions

Section 6662 provides for the imposition of accuracy-related penalties. The accuracy-related penalties are imposed on the portion of the underpayment of tax required to be shown on a return attributable to negligence (section 6662(b)(1)), a substantial understatement of tax (section 6662(b)(2)), and a substantial valuation misstatement (section 6662(b)(3)). The penalty applies only to that portion of the underpayment attributable to the particular type of misconduct. The maximum accuracy-related penalty imposed on a portion of an underpayment may not exceed 20 percent of such portion (40 percent of the portion attributable to a gross valuation misstatement per section 6662(h)), notwithstanding that such portion is attributable to more than one type of misconduct. Treas. Reg. § 1.6662-2(c). Different portions of a single income tax return may be subject to penalties imposed for different types of misconduct.

Additional rules under section 6662(e)(1)(B) impose a penalty on any underpayment of income tax attributable to a substantial valuation misstatement pertaining to either a transaction between persons described in section 482 (the “transactional penalty”) or a net section 482 transfer price adjustment (the “net adjustment penalty”). The penalty is equal to 20 percent of the underpayment of tax attributable to that substantial valuation misstatement. Pursuant to section 6662(h), the penalty is increased to 40 percent of the underpayment in the case of a gross valuation misstatement with respect to either the transactional penalty or net adjustment penalty. In any year, no penalty is imposed under these rules unless the underpayment of tax attributable to all valuation misstatements exceeds a dollar limitation of \$5,000 in the case of an individual, S corporation and personal holding companies (as defined by I.R.C. section 542) or \$10,000 in the case of a corporation. I.R.C. § 6662(e)(2). This dollar limitation must be met for each year in which the penalty will be asserted, including carryback and carryover years of any valuation misstatements. Treas. Reg. § 1.6662-5(b). The section 6662(e)(1)(B) and (h) penalty provisions are applicable to any tax year ending after November 5, 1990. Omnibus Budget Reconciliation Act of 1990, Pub. L. 101-508, Title XI, sec. 11312, 104 Stat. 1388 (1990).

Final regulations for sections 6662(e)(1)(B) and (h) became effective on February 9, 1996. Treas. Reg. § 1.6662-6. These regulations set forth special rules in the case of carrybacks and carryovers, and coordination rules between these penalties. Treas. Reg. §§ 1.6662-6(e) and (f), respectively. In particular, Treas. Reg. § 1.6662-6(e) sets forth special rules for carrybacks and carryovers:

If there is a substantial or gross valuation misstatement for a taxable year that gives rise to a loss, deduction or credit that is carried to another taxable year, the transactional penalty and the net adjustment penalty will be imposed on any resulting underpayment of tax in that

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other taxable year. In determining whether there is a substantial or gross valuation misstatement for a taxable year, no amount carried from another taxable year shall be included.

Treas. Reg. § 1.6662-6(e).

In other words, section 482 valuation misstatements made in one year that give rise to an underpayment of tax in a prior or subsequent year are not grouped with misstatements made in that prior or subsequent year for purposes of determining whether the valuation misstatement is substantial or gross in nature. The character and penalty rate of the misstatement are determined in the year the misstatement is made, not in any other year in which the misstatement gives rise to an underpayment of tax.

In the case of multiple section 482 adjustments to which the Penalties apply, one must consider the coordination rules under Treas. Reg. § 1.6662-6(f). Treas. Reg. § 1.6662-6(f) sets forth rules for coordinating between the 20 percent substantial valuation misstatement penalty and the 40 percent gross valuation misstatement penalty when both the transactional and net adjustment penalty are present:

(1) In determining whether a net section 482 adjustment exceeds five million dollars or 10 percent of gross receipts, an adjustment attributable to a substantial or gross valuation misstatement that is subject to the transactional penalty will be taken into account. If the net section 482 adjustment exceeds five million dollars or ten percent of gross receipts, any portion of such amount that is attributable to a gross valuation misstatement will be subject to the transactional penalty at the forty percent rate. The remaining amount is subject to the net adjustment penalty at the twenty percent rate, even if such amount is less than the lesser of five million dollars or ten percent of gross receipts.

(2) If the net section 482 adjustment exceeds twenty million dollars or 20 percent of gross receipts, the entire amount of the adjustment is subject to the net adjustment penalty at a forty percent rate. No portion of the adjustment is subject to the transactional penalty at a twenty percent rate.

Treas. Reg. § 1.6662-6(f).

Additionally, Treas. Reg. § 1.6664-3 provides rules for determining the order in which multiple adjustments to a return are taken into account for the purpose of computing the total amount of penalties imposed under sections 6662 and 6663. These ordering rules do not make any exception for, or distinction between,

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penalties based upon section 482 adjustments. Section 1.6664-3(a) provides that the ordering rules of subsection 3(b) apply where (1) there is at least one adjustment with respect to which no penalty has been imposed and at least one with respect to which a penalty has been imposed, or (2) there are at least two adjustments with respect to which penalties have been imposed and they have been imposed at different rates. Section 1.6664-3(b) provides that adjustments are considered made in the following order:

- (1) Those with respect to which no penalties have been imposed.
- (2) Those with respect to which a penalty has been imposed at a 20 percent rate (*i.e.*, a penalty for negligence or disregard of rules or regulations, substantial understatement of income tax, or substantial valuation misstatement, under sections 6662(b)(1) through 6662(b)(3), respectively).
- (3) Those with respect to which a penalty has been imposed at a 40 percent rate (*i.e.*, a penalty for a gross valuation misstatement under sections 6662(b)(3) and (h)).
- (4) Those with respect to which a penalty has been imposed at a 75 percent rate (*i.e.*, a penalty for fraud under section 6663).

Treas. Reg. § 1.6664-3(b).

The examples in Treas. Reg. § 1.6664-3(d) demonstrate these ordering rules.

Analysis and Conclusions

Current Year Loss - Multiple Adjustments Resulting in Taxable Income

Your first question is:

Assume a domestic corporation reported a current year loss on an originally filed income tax return. Upon audit, both a section 482 and a non-section 482 adjustment are proposed. The section 482 adjustment constitutes a substantial valuation misstatement under section 6662(e)(1)(B), *i.e.*, the dollar or percentage thresholds are met, and there is no reasonable cause established under section 6664(c).¹ Thus the misstatement is subject to the

¹ Treas. Reg. § 1.6662-6(c)(6) provides that for purposes of establishing the reasonable cause and good faith exception of section 6664(c) with respect to the net section 482 adjustment penalty the documentation requirements of Treas. Reg. §

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20 percent penalty under section 6662(a). How is the originally filed loss overcome? Is there an ordering rule to apply the adjustments to the loss? In your response, assume the following facts:

Taxable income or <loss> per return	\$ <10,000,000>
Non-section 482 adjustment	\$ 20,000,000
Section 482 adjustment (subject to 6662(e)(1)(B))	<u>\$ 15,000,000</u>
Total adjustments	\$ 35,000,000
Taxable income, as corrected	\$ 25,000,000

As discussed above, Treas. Reg. § 1.6664-3 applies in determining the order in which multiple adjustments are taken into account for purposes of computing section 6662 and 6663 penalties. Your example, however, does not indicate whether the “non-section 482 adjustment” is one for which a penalty applies. The non-section 482 adjustment could be one for which no penalty, a 20 percent, a 40 percent penalty or a 75 percent penalty applies. The example does provide that the “section 482 adjustment” is subject to a penalty under sections 6662(e)(1)(B) and 6662(a). Assuming the section 482 adjustment is subject to the 20 percent rate, and applying the ordering rules of section 1.6664-3(b), there are three possible results. They are: (1) the non-section 482 adjustment is not subject to any penalty, therefore, is the first adjustment under the ordering rules and the section 482 adjustment is the second adjustment; (2) the non-section 482 adjustment is subject to a 20 percent penalty, therefore, the ordering rules do not apply because both penalties are at the same rate; and (3) the non-section 482 adjustment is subject to a 40 or 75 percent penalty, therefore, the section 482 adjustment at a 20 percent penalty rate is the first adjustment under the ordering rules and the non-section 482 adjustment is the second adjustment.²

1.6662-6(d) must be satisfied. Treas. Reg. § 1.6662-6(b)(3) provides that for purposes of establishing the reasonable cause and good faith exception of section 6664(c) with respect to the section 482 transactional penalty the rules of Treas. Reg. § 1.6664-4 apply; however, satisfaction of the documentation requirements of Treas. Reg. § 1.6662-6(d) is considered reasonable cause and good faith under Treas. Reg. § 1.6664-4.

² If the section 482 adjustment is subject to the 40 percent gross valuation penalty then any non-section 482 adjustment for which no penalty applies and any adjustment for which a 20 percent penalty applies precedes the section 482 adjustment subject to the 40 percent penalty rate. Any adjustment for which a 40 percent penalty applies is not subject to the ordering rules because both penalties are at the same rate. Any non-section 482 adjustment subject to a 75 percent penalty rate applies last.

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If one assumes that (1) the non-section 482 adjustment is an adjustment for which no penalty applies, (2) that the section 482 adjustment is subject to a 20 percent penalty and (3) that the income tax rate is 35 percent³, the calculation of the penalty is calculated as follows:

Step 1: Adjustments not subject to a penalty

The first step is to calculate the amount of the underpayment of tax attributable to adjustments not subject to a penalty, which in this case is the non-section 482 adjustment.

1.	Taxable income or <loss> per return	\$<10,000,000>
2.	Adjustment 1: non-section 482 adjustment	<u>\$ 20,000,000</u>
3.	Adjusted taxable income, as corrected	\$ 10,000,000

Here, the \$10,000,000 loss is absorbed against the adjustment for which there is no penalty.

Step 2: Adjustments subject to a 20 percent penalty

The next step is to determine the amount of underpayment of tax attributable to adjustments subject to 20 percent penalties. In this case, the section 482 adjustment is the only adjustment subject to a 20 percent penalty. Starting with the adjusted taxable income, as corrected, from Step 1, one determines the total taxable income, as corrected, with the 20 percent penalty adjustments.

4.	Adjusted taxable income (from line 3)	\$ 10,000,000
5.	Adjustment 2 - section 482 adjustment	<u>\$ 15,000,000</u>
6.	Total taxable income, as corrected	\$ 25,000,000

Step 3: Calculation of underpayment

Next, the underpayment of tax attributable to the 20 percent penalty adjustment is determined. The underpayment is determined by calculating the tax on the total taxable income, as corrected, determined in Step 2 and subtracting from that amount the tax determined in Step 1 for adjustments on which no penalty was asserted.

³ In the interest of simplicity, we have assumed that the applicable income tax rate is always 35 percent; however, Treas. Reg. § 1.6664-3(d) *Example 1* uses graduated income tax rates to calculate the portion of the understatement of income tax attributable to each adjustment. See Lemishow v. Commissioner, 110 T.C. 346 (1998).

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7.	Income tax on corrected taxable income (35% of \$25,000,000)	\$ 8,750,000
8.	Tax on Adjustment 1 (35% of \$10,000,000)	<u>\$ 3,500,000</u>
9.	Underpayment of tax from Adjustment 2	\$ 5,250,000

Step 4: Calculation of Penalty

Next, the amount of the penalty is determined by multiplying the penalty rate times the underpayment of tax determined in Step 3.

10.	Underpayment of tax from Adjustment 2	\$ 5,250,000
11.	Penalty rate	<u>20%</u>
11.	Penalty amount	\$ 1,050,000

Based upon the assumptions made above and pursuant to the ordering rules of Treas. Reg. § 1.6664-3, the underpayment of income tax that is attributable to the section 482 adjustment of \$15,000,000 is \$5,250,000. Once the amount of the underpayment of tax is determined, the appropriate penalty rate is multiplied by the underpayment to determine the penalty (addition to tax) from this valuation misstatement, which is \$1,050,000 in this example. Last, the underpayment of tax attributable to the valuation misstatement is compared to the dollar limitation of section 6662(e)(2), *i.e.*, \$5,000 or \$10,000 as applicable, to assure that it exceeds the limitation for the taxable year. In this example, the underpayment of tax exceeds the dollar limitation.

Current Year Loss - Multiple Adjustments Not Overcoming NOL

Your second question is:

Assume a domestic corporation reported a current year loss on an originally filed income tax return. On audit, a section 482 adjustment is proposed. Although the adjustment does not overcome the loss on the return as filed, the section 482 adjustment constitutes a substantial valuation misstatement under section 6662(e)(1)(B), *i.e.*, the dollar or percentage thresholds are met, and there is no reasonable cause established under section 6664(c).⁴ Thus the misstatement is subject to the 20 percent penalty under section 6662(a). How is the penalty calculated in the following example?

Taxable income or <loss> per on return	\$ <10,000,000>
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⁴ See footnote 1.

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Section 482 adjustment	\$ 8,000,000
Taxable income or <loss>, as corrected	\$ <2,000,000>

Here, the proposed section 482 adjustment does not exceed the current year loss. Under section 6662(a), a section 6662 penalty can not be applied in a year where there is no underpayment of income tax. I.R.C. § 6664(a), Treas. Reg. §§ 1.6662-2(a) and 1.6664-2. Although there is no underpayment of income tax attributable to the substantial valuation misstatement for the current tax year, the substantial valuation misstatement may give rise to an underpayment of tax in a prior or subsequent tax year. The answer to your third question contains an example demonstrating how the Penalties apply in these circumstances.

NOL Carryforward Offset

Your third question is:

Assume a domestic corporation reported current year income on an originally filed income tax return, but the taxable income is reduced to zero by a NOL carryforward. On audit, a section 482 adjustment is proposed. The section 482 adjustment constitutes a substantial valuation misstatement under section 6662(e)(1)(B), *i.e.*, the dollar or percentage thresholds are met, and there is no reasonable cause established under section 6664(c).⁵ Thus the misstatement is subject to the 20 percent penalty under section 6662(a). Assuming the adjustment does not overcome the NOL carryforward, may the section 6662(e)(1)(B) penalty be calculated and imposed? For example, assume:

Taxable income for Year 2 per return	\$ 10,000,000
NOL carryforward from Year 1 per return	\$ <30,000,000>
Adjusted taxable income or <loss> per return	\$ <20,000,000>

Section 482 adjustments to Year 2 taxable income \$ 18,000,000

Adjusted taxable income for Year 2, as corrected \$ <2,000,000>

No penalty may be calculated in Year 2 because, as in your second question, there is no underpayment of tax attributable to a substantial or gross valuation misstatement due to the NOL carryforward.

Although no penalty attaches to the valuation misstatement in Year 2 because there is no underpayment of income tax, there may be a penalty in a year prior or

⁵ See footnote 1.

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subsequent to Year 2. Treas. Reg. § 1.6662-6(e) addresses situations where a NOL carryforward (or carryback) is attributable to a substantial or gross valuation misstatement which gives rise to an underpayment of tax in another year.⁶ In Year 2, the taxpayer's valuation misstatement reduced taxable income (before application of the Year 1 NOL) from \$28,000,000 (as corrected for the Year 2 return) to \$10,000,000 (per Year 2 return). Although this valuation misstatement did not create an underpayment of income tax in Year 2, a taxpayer might carry over the balance of the NOL as reported, \$<20,000,000>, instead of the balance of the NOL as corrected, \$<2,000,000>, and apply this amount against another year's taxable income. An underpayment of income tax attributable to the Year 2 valuation misstatement in Year 3 will exist if taxpayer offsets such taxable income through application of a residual NOL in an amount greater than \$2,000,000.⁷ Treas. Reg. § 1.6662-6(e).

For example, assume the same taxpayer had \$35,000,000 of current year income in Year 3, that the effective tax rate is 35 percent⁸ and a section 6662(e)(1)(B) penalty is imposed at the 20 percent rate:

Taxable income for Year 3 per return	\$ 35,000,000
NOL carryforward from Year 2 per return	\$ <20,000,000>
Adjusted taxable income for Year 3 per return	\$ 15,000,000
NOL carryforward attributable to Year 2	
Section 482 valuation misstatement ⁹	\$ <u>18,000,000</u>
Adjusted taxable income for Year 3, as corrected	\$ 33,000,000

⁶ Treas. Reg. § 1.6662-6(e) addresses a "valuation misstatement for a taxable year that gives rise to a loss, deduction or credit that is carried to another year . . ." In our view, this includes a loss carryforward or carryback that is under-absorbed on account of a valuation misstatement that arises in an intermediate year.

⁷ One should look to the NOL carryforward and carryback ordering rules to determine priority of NOLs arising from different years. In the following example, we assume that the remaining \$2,000,000 Year 1 NOL is absorbed first.

⁸ See footnote 3.

⁹ The adjustment to the Year 1 NOL carryforward is based upon the section 482 adjustment made to the taxable income reported for Year 2 that reduced the residual NOL carryforward available in Year 3.

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Assuming no other adjustments, the underpayment of income tax in Year 3 attributable to the Year 2 section 482 valuation misstatement is calculated as follows:

Adjusted taxable income for Year 3, as corrected	\$ 33,000,000
Less adjusted taxable income for Year 3, per return	<u>\$ 15,000,000</u>
Understatement of taxable income for Year 3	\$ 18,000,000

The penalty imposed in Year 3 is calculated as follows:

Income tax on corrected taxable income (35% of \$33,000,000)	\$ 11,550,000
Tax on Year 3 taxable income, per return (35% of \$15,000,000)	<u>\$ 5,250,000</u>
Underpayment of income tax in Year 3	\$ 6,300,000
Penalty rate	<u>20%</u>
Penalty amount	\$ 1,260,000

In the above example, the valuation misstatement made in Year 2 did not have a tax underpayment effect until Year 3 when the overstated NOL carryforward improperly reduced taxable income and consequently gave rise to an underpayment of income tax for Year 3. Pursuant to the rules in Treas. Reg. § 1.6662-6(e)¹⁰, the valuation misstatement penalty is imposed in the year in which the underpayment of tax related to the misstatement occurs, *i.e.*, Year 3 in this example. Therefore, for Year 3, the valuation misstatement penalty is equal to the penalty rate multiplied by the underpayment of tax attributable to the Year 2 valuation misstatement giving rise to the underpayment of tax in Year 3. In this case, the entire understatement of \$18,000,000 was improperly absorbed in Year 3 and gave rise to an underpayment of tax. Since the underpayment of tax exceeds the section 6662(e)(2) dollar limitation, the penalty may be imposed, assuming reasonable cause under section 6664(c) is not established as to the Year 2 valuation misstatement.

Application of Treas. Reg. § 1.6662-6

Your fourth question is:

Assume a section 482 adjustment is made, and the Penalties apply. Do all of the section 6662 regulations apply to this adjustment, or do only the regulations under Treas. Reg. § 1.6662-6 apply? If pertinent examples are

¹⁰ In this case the NOL carried from Year 1 to Year 2 is valid, but the NOL carried from Year 2 to Year 3 was, in part, attributable to a section 482 valuation misstatement.

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shown throughout the section 6662 and 6664 regulations, do these provisions apply to the Penalties?

The general rule is that to the extent Code sections and attendant regulations are not mutually exclusive or inconsistent and can be interpreted together, the provisions must be construed together. Estate of Sanford v. Commissioner, 308 U.S. 39 (1939)(estate and gift tax are *in pari materia* and must be construed together); Faulkner v. Commissioner, 88 T.C. 623 (1987)(application of *in pari materia* construction of laws to interpretation of statute and regulations). To the extent that the statutes or regulations cannot be read together, the more specific provision provides guidance rather than the broader provision. Bulova Watch Co. v. United States, 365 U.S. 753 (1961) (restating that a specific statutory provision will override a general provision). See also D. Ginsberg & Sons, Inc. v. Popkin, 285 U.S. 204, 208 (1932); and Nelson v. Commissioner, 110 T.C. 114 (1998).

To the extent considered here, the statutory provisions of sections 6662 and 6664 and attendant regulations do not conflict; therefore, they may be construed together harmoniously. For example, Treas. Reg. § 1.6662-6 has special rules for determining the classification of a section 482 penalty as a 20 percent substantial valuation misstatement or as a 40 percent gross valuation misstatement. Once the classification and penalty rate for a section 482 valuation misstatement is determined, the ordering rules under Treas. Reg. § 1.6664-3 apply. Also, Treas. Reg. § 1.6662-6(e) provides special rules regarding the application of the Penalties to carryforwards and carrybacks for section 482 valuation misstatements under section 6662(e)(1)(B) and (h).

If you have additional questions, please call (202) 874-1490.

By: _____

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