



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

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: Accuracy-Related and Fraud Penalties -- Carryback

This Field Service Advice responds to your memorandum dated August 13, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

Taxpayer	=
A	=
B	=
C	=
D	=
Date 1	=
Year 1	=
Year 2	=
Year 3	=
\$	=
\$\$	=
\$\$\$	=
X	=
Y	=
Court	=

ISSUES

Whether the I.R.C. § 6662 accuracy-related penalty or the § 6663 fraud penalty may be imposed on Taxpayer for the Year 1 taxable year where the capital losses generated in Year 3 by a partnership formed by Taxpayer, were carried back to

Year 1 by Taxpayer's amended return which requested a refund that was not allowed by the IRS.

CONCLUSIONS

The Year 1 amended return did not generate a rebate or result in an underpayment that is subject to the accuracy-related penalty under § 6662 or the fraud penalty under § 6663. Thus, the accuracy-related penalty and fraud penalty are not applicable to the disallowed refund amount requested in the amended return for Year 1.

FACTS

On Date 1, Taxpayer, sold its wholly owned subsidiary, A, and related assets. This sale generated a capital gain of approximately \$\$\$\$. In Year 2, Taxpayer formed D to engage in transactions to generate phantom capital losses to offset the A gain. D is one of X partnerships formed with the assistance of C as the vehicle for creating large capital losses to offset large gains through the use of the § 453 installment sales provisions. **

In Year 3, D claimed a capital loss of \$\$\$. At that time, Taxpayer and its wholly owned subsidiary, B, a member of Taxpayer's consolidated group, held more than a Y percent interest in D. Taxpayer claimed a tax loss of \$\$ for Year 3 and filed an amended Year 1 return carrying the loss back to Year 1. Based on a Court opinion in ** only \$ of that loss was allowed.

The Service did not act upon Taxpayer's refund claim, presumably, because it stemmed from a TEFRA partnership that was under audit. The transcript of account for Taxpayer also reflects no activity relating to the carryback claim.

LAW AND ANALYSIS

For returns due after December 31, 1989, § 6662 imposes an accuracy-related penalty on any portion of an underpayment attributable to misconduct set forth in § 6662(b)(2). The amount of the penalty is 20 percent of the portion of the underpayment resulting from the misconduct. The penalty is increased to 40 percent in the case of a gross valuation misstatement. I.R.C. § 6662(h). The accuracy-related penalty for negligence, disregard of rules or regulations, a substantial understatement, or a substantial or gross valuation misstatement applies to any portion of an underpayment for a year to which a loss, deduction or credit is carried, when the portion is attributable to negligence, disregard of rules or regulations, a substantial understatement or a substantial or gross valuation misstatement in the year in which the carryback or carryover of the loss, deduction, or credit arises (the "loss or credit year"). Treas. Reg. § 1.6662-3(d)(1), Treas. Reg. § 1.6662-4(c)(3), Treas. Reg. § 1.6662-5(c)(1). The 20 percent accuracy-related penalty is imposed on any portion of an underpayment for a carryback year,

the return for which is due (without regard to extensions) before January 1, 1990, if that portion of the underpayment is attributable to negligence, disregard of rules or regulations, a substantial understatement, or a substantial valuation misstatement in a loss or credit year, and the return for the loss or credit year is due (without regard to extensions) after December 31, 1989. Treas. Reg. § 1.6662-3(d)(2), Treas. Reg. § 1.6662-4(c)(4), Treas. Reg. § 1.6662-5(c)(2). Similarly, the 40 percent accuracy-related penalty is imposed on any portion of an underpayment for a carryback year, the return for which is due (without regard to extensions) before January 1, 1990, if that portion of the underpayment is attributable to a gross valuation misstatement in a loss or credit year, and the return for the loss or credit year is due (without regard to extensions) after December 31, 1989. Treas. Reg. § 1.6662-5(c)(2).

Section 6663 provides for the imposition of a penalty for fraud. The fraud penalty, imposed at the rate of 75 percent, applies to the portion of an underpayment attributable to fraud. I.R.C. § 6663. A deficiency is due to fraud where it is caused by the carryback or carryover of a fraudulent loss. See e.g., Arc Electrical Construction Co. v. Commissioner, 923 F.2d 1005 (2^d Cir. 1991).

It can be concluded from the language of §§ 6662 and 6663 that an underpayment is a prerequisite to imposition of the penalty thereunder. In the case of income taxes imposed under subtitle A, an underpayment for purposes of the fraud penalty as well as the accuracy-related penalty means the amount by which any income tax imposed, exceeds the excess of (1) the sum of the amount shown as the tax by the taxpayer on his return and the amounts not so shown but either previously assessed or collected without assessment over (2), the amount of rebates. I.R.C. § 6664; Treas. Reg. § 1.6664-2(a). The term “rebate” means so much of an abatement, credit, refund or other repayment, as was made on the ground that the tax imposed was less than the excess of (1) the amount shown as the tax by the taxpayer on his return and amounts not so shown previously assessed or collected without assessment over (2) rebates previously made. The definition of rebate for purposes of §§ 6662 and 6664 is similar to the definition of rebates under § 6211 (b)(2) for purposes of determining a tax deficiency under § 6211. Treas. Reg. § 301.6211-1(f).

Courts have found that a rebate was generated when the IRS has recalculated a taxpayer’s tax liability and issued a tax refund or credit for a given year as a result of an amended return filed or tentative carryback adjustment claimed by a taxpayer. See e.g., Pesch v. Commissioner, 78 T.C. 100 (1982) and Baldwin v. Commissioner, 97 T.C. 704 (1991). In Pesch, where a tentative carryback adjustment resulted in a tax refund, the Tax Court held that such tax refund was a “rebate” under § 6211(b)(2). Similarly, in Baldwin, the Tax Court held that a credit against unpaid taxes that is allowed as a result of a tentative carryback adjustment for a net operating loss under § 6411 constitutes a “rebate” within the meaning of § 6211(b)(2).

Courts have not found that a rebate was generated where the IRS rejected an amended return or a tentative carryback adjustment and did not issue a tax refund or credit. See e.g., Fayeghi v. Commissioner, T.C. Memo. 1998-297 and Dover Corporation v. Commissioner, T.C. Memo. 1997-339, aff'd per curiam, 148 F.3d 70 (2d Cir. 1998). In Fayehi, the Commissioner did not accept taxpayers' amended return which reflected that the correct tax liability was less than the tax reflected on the original return. In rejecting taxpayers' effort to bar collection of the difference between the tax liability reported on the original return and the tax liability reflected on the amended return on the ground that the amount was a rebate that caused a tax deficiency, the Tax Court agreed with the Commissioner that rejection of a claim for refund or abatement in an amended return does not convert the disallowed claim into a deficiency. Similarly, in Dover, the Tax Court held that the Commissioner's rejection of a corporation's amended returns for two tax years, which were filed after the issuance of the notice of deficiency for those years, did not convert the disallowed claims for refund into deficiencies for those years.

In the instant case, the IRS rejected Taxpayer's amended return. As a result, the IRS did not recalculate or reduce Taxpayer's Year 1 liability or issue a refund or credit to Taxpayer on the basis that the tax reported was less than the correct amount of tax. As a consequence, the Year 1 amended return did not generate a rebate or result in an underpayment that is subject to the accuracy-related penalty under § 6662 or the fraud penalty under § 6663. Thus, the accuracy-related and fraud penalties are not applicable to the disallowed refund amount requested in the amended return for Year 1.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



If you have any further questions, please call Willie E. Armstrong, Jr., at (202) 622-7920.

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