



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

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE
SIGNIFICANT SERVICE CENTER ADVICE

MEMORANDUM FOR: ASSOCIATE AREA COUNSEL
(Small Business/Self-Employed)

FROM: Assistant Chief Counsel (Administrative Provisions & Judicial Practice) CC:PA:APJP

SUBJECT: Managerial Approval and Notice Requirements of Penalties - Section 6751(b)

This Significant Service Center Advice responds to your memorandum dated September 28, 2001. In accordance with I.R.C. § 6110(k)(3), this Significant Service Center Advice should not be cited as precedent.

ISSUE

Whether the section 6662 accuracy-related penalties for negligence and substantial understatement assessed pursuant to the Automated Underreporter program qualify under section 6751(b)(2)(B) as penalties automatically calculated through electronic means that are excepted from the general rule requiring written supervisory approval of penalties.

CONCLUSION

When the section 6662 penalties are assessed under the Automated Underreporter program without an employee independently determining the appropriateness of the penalty, the penalty is one automatically calculated through electronic means and may be assessed without written supervisory approval of the penalty. Where, however, a Service employee considers a taxpayer response to a proposed penalty, section 6751(b)(1) requires written approval of the penalty by the employee's immediate supervisor prior to assessment of the penalty.

FACTS

The Automated Underreporter program is a document matching program. The program compares a taxpayer's return with third party information returns concerning the taxpayer. If there is a discrepancy between the two, the computer program calculates a proposed deficiency and prepares a letter to the taxpayer requesting the taxpayer to explain the discrepancy. If the taxpayer responds, a tax examiner will consider the response and may adjust the proposed deficiency as appropriate. If the taxpayer does not respond, the program issues a notice of deficiency automatically. If the taxpayer does not respond to the notice of deficiency, the deficiency will then be assessed.

If the understatement of tax that the program initially calculates exceeds the greater of (a) ten percent of the tax that should have been shown on the return or (b) \$5,000 (\$10,000 for corporations), the computer will automatically include in its initial letter to the taxpayer a proposed substantial understatement penalty in accordance with the provisions of section 6662(d)(1)(A). If the taxpayer replies neither to that letter nor to the notice of deficiency that the computer program subsequently issues, no human will consider or review the penalty and it will be automatically assessed.

In other circumstances, the Automated Underreporter program asserts the negligence penalty under section 6662(b)(1). These circumstances arise when the program identifies a taxpayer as an underreporter who also underreported, and was assessed, a deficiency in a prior year. If the taxpayer responds neither to the letter nor the deficiency notice that the computer generates and sends to him, the program will assess the negligence penalty without any human considering the appropriateness of the penalty.

ANALYSIS

Section 6751(b)(1) provides that no penalty "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." As an exception to this general rule, section 6751(b)(2) provides that managers need not approve any addition to tax under section 6651, 6654, or 6655; or any other penalty automatically calculated through electronic means.

Nothing in the legislative history to section 6751 explains what is meant by "penalty automatically calculated through electronic means." We believe that it means something more than merely using an electronic device to perform arithmetic functions to determine the amount of a penalty. If the phrase meant nothing more, then the assessment of any penalty could potentially qualify as an exception to the general rule requiring supervisory approval. Instead, by analogy to the manner in

which the Service uses automated computer programs to assess penalties under section 6651, 6654 and 6655, we believe that assessment of a penalty qualifies as one calculated through electronic means if the penalty is assessed free of any independent determination by a Service employee as to whether the penalty should be imposed against a taxpayer.

As explained above, the Automated Underreporter program will, in certain circumstances, cause an automatic assessment of accuracy-related penalties for negligence or substantial understatement. Outside the context of assessment under the Automated Underreporter program, these penalties typically require an independent determination of the appropriateness of the penalty. For example, the determination that there is negligence typically requires a Service employee to make an independent determination of whether a taxpayer made a reasonable attempt to comply with the provisions of the internal revenue laws or to exercise ordinary and reasonable care in the preparation of a tax return. Treas. Reg. § 1.6662-3(b)(1). When an employee makes such a determination, there is not an automatic calculation of the penalty through electronic means and the exception to the general rule requiring written supervisory approval would not apply.

The circumstances in which the Automated Underreporter program calls for assessment of a negligence penalty, however, does not require an independent determination by a Service employee. Instead, programmed into the computer are uniform factual criteria under which the computer will automatically propose a negligence penalty; when a taxpayer, for a second year, fails to report income reported on third party information returns, the programmed determination is that the taxpayer has not exercised ordinary and reasonable care in the preparation of his return. When the computer program automatically assesses the penalty on the basis of this mechanical determination, we believe that it qualifies as an exception to the general rule requiring written supervisory approval.

The analysis is similar with respect to the substantial understatement penalty. The Automated Underreporter program electronically calculates when income reported on third party information returns, but omitted from a taxpayer's return, falls within the dollar amount criteria of section 6662(d)(1)(A) and qualifies as a substantial understatement. We note that, under section 6662(d)(2)(B), a taxpayer may sometimes avoid the substantial understatement penalty by having substantial authority for the tax treatment of an item or by disclosing certain information affecting an item's tax treatment if there is a reasonable basis for that tax treatment. Consideration of these matters would require a Service employee to make an independent determination of the appropriateness of the penalty and require the written approval of an immediate supervisor before the penalty could be assessed. We understand, however, that the Automated Underreporter program does not involve returns with disclosure statements. See Treas. Reg. § 1.6662-4(f). Furthermore, without a taxpayer providing an explanation for omission of income reported on a third party information return, the Service would have no basis to

believe that there was substantial authority for omitting the income. Therefore, we believe that the Automated Underreporter program is appropriately asserting the substantial understatement penalty when the taxpayer omits income on his return in amounts that meet the criteria of section 6662(d)(1)(A). Furthermore, because the program automatically calculates and proposes the penalty, we believe that the penalty qualifies as one automatically calculated by electronic means and may be assessed without supervisory approval so long as the taxpayer does not respond to the proposed penalty prior to its assessment.

Of course, if a taxpayer responds either to the initial letter proposing a penalty or to the notice of deficiency that the program automatically issues, a Service employee will have to consider the response. When considering the response, the employee will have to make an independent determination as to whether the response provides a basis upon which the taxpayer may avoid the penalty. Whether the employee determines to apply the penalty or not, the employee's independent determination of whether the penalty is appropriate means that the penalty is not automatically calculated through electronic means. Accordingly, section 6751(b)(1) would require written supervisory approval of an employee's determination to assert the penalty.

If you have questions, please contact us.

By: CURTIS G. WILSON
Ashton P. Trice
Senior Technician Reviewer
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