

Office of Chief Counsel
Internal Revenue Service
Memorandum

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(Small Business/Self-Employed)

from: Ashton P. Trice
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subject: Section 6676 Penalty

This memorandum responds to your question about the correct procedures for assessing the section 6676 penalty against a taxpayer who received an excessive refund based on an erroneously claimed American Opportunity Credit.

Issue:

Is the section 6676 penalty subject to deficiency procedures before it is assessed against a taxpayer who makes an erroneous claim for refund based on the section 25A(i) American Opportunity Credit?

Conclusion:

As a general rule, assessment of a penalty is subject to deficiency procedures when the penalty is dependent upon the determination of a deficiency. Claims for refund based on disallowed refundable credits, like the section 25A(i) American Opportunity Credit, are taken into account as negative tax when calculating a deficiency and deficiency procedures apply. The section 6676 penalty cannot apply to a refund claim based on the American Opportunity Credit unless that claimed credit is part of a deficiency. Therefore, where the section 6676 penalty applies to a disallowed American Opportunity Credit, assessment of the penalty is also subject to deficiency procedures.

Background:

On her Form 1040, a taxpayer correctly reported income tax liability of . She claimed a refund of \$, consisting of \$ of income tax withheld, a \$ Earned Income Credit (EIC), and a \$ American Opportunity Credit. Upon examination, it was determined that the taxpayer was not entitled to the American Opportunity Credit because the taxpayer paid all of her qualified education expenses with scholarships and grants. Disallowance of the American Opportunity Credit resulted in a \$ deficiency. The Service also intends to assess a section 6676 penalty against the taxpayer as a result of her claim for refund in an excessive amount.

Law and Analysis:

Section 6676 imposes a penalty where a taxpayer claims a refund or credit in an excessive amount without any reasonable basis for making such claim. Sec. 6676(a). The amount of the penalty is equal to 20 percent of the excessive amount claimed. Id. Section 6676 does not apply where the excessive refund or credit was claimed pursuant to section 32, the Earned Income Credit (EIC). Id. It is also inapplicable to any part of a claim for refund or credit that is subject to the accuracy-related penalty under section 6662, the understatement penalty on reportable transactions under section 6662A, or the fraud penalty under section 6663. See sec. 6676(d).

No court has yet considered whether the section 6676 penalty is subject to deficiency procedures. Nonetheless, applicable statutory provisions and case law lead to the conclusion that deficiency procedures apply to the 6676 penalty only if a taxpayer claims an excessive refund or credit based on one of the refundable credits described in section 6211(b)(4), other than the EIC.

Section 6665(a) states that the additions to tax, additional amounts, and penalties provided by Chapter 68 shall be assessed, collected, and paid in the same manner as “taxes.” Section 6671(a), which appears – along with section 6676 – in Subchapter B of Chapter 68, also states that the penalties provided by that subchapter shall be assessed and collected in the same manner as “taxes.” However, the Code provides for many different types of “taxes.” Some, like income taxes, are subject to deficiency procedures while others, such as employment taxes, are not. Because no one set of procedures applies to all taxes, no one set of procedures can apply to all penalties.

In interpreting sections 6665 and 6671, the Tax Court has applied a rule that, when a penalty is dependent upon the determination of a deficiency, then that penalty is also subject to deficiency procedures. If a penalty is not dependent on the determination of a deficiency, then the penalty is not subject to deficiency procedures. See Smith v. Commissioner, 133 T.C. 424, 429 (2009) (“We conclude that section 6707A penalties are not included in the statutory definition of ‘deficiency.’ See secs. 6671, 6211. Section 6707A penalties do not depend upon a deficiency. They may be assessed even if there is an overpayment of tax. The IRS imposes the penalty for failure to disclose a reportable transaction. We note that this Court has never exercised jurisdiction over an

assessable penalty that was not related to a deficiency, even absent Congress' explicitly circumscribing our jurisdiction.”)

The American Opportunity Credit provided by Section 25A(i) is one of the refundable credits listed in section 6211(b)(4). Refunds claimed on the basis of such credits are taken into account as negative tax when determining the amount of a deficiency. See sec. 6211(b)(4). Because a disallowed refund attributable to an erroneously claimed refundable credit is part of the deficiency determination, any section 6676 penalty on the disallowed refund will also depend on the deficiency determination.

Here, the taxpayer received a refund on the basis of an erroneously claimed American Opportunity Credit, resulting in a \$ deficiency. If the Tax Court were to conclude that she properly claimed the refundable credit, no deficiency would exist and there would be no claim for excessive refund to which the section 6676 penalty could apply. By contrast, if the court were to agree with the Service's deficiency determination and find that the taxpayer was not entitled to the refundable credit, the section 6676 penalty could apply to her claim for excessive refund. Because applicability of the section 6676 penalty to this taxpayer depends of the determination of a deficiency, deficiency *procedures will also apply to the penalty. If the Service intends to assess the penalty, it should be included in the statutory notice of deficiency issued to the taxpayer.

The section 6662 accuracy-related penalty does not apply to this taxpayer because that penalty only applies where there is an underpayment of tax. Treas. Reg. § 1.6664-2(a) defines an underpayment of income tax as the excess of the amount of income tax imposed under Subtitle A over the excess of (A) the sum of (i) the amount shown as the tax by the taxpayer on his return, plus (ii) amounts not so shown but previously assessed (or collected without assessment), over (B) the amount of rebates made. This definition may also be expressed as a formula: $W - (X + Y - Z)$, where W is the amount of income tax imposed; X is the amount shown as the tax on the taxpayer's return; Y is the amount not so shown but previously assessed (or collected without assessment); and Z is the amount of any rebates made. Id.

Under the Tax Court's opinion in Rand v. Commissioner, 141 T.C. 376 (2103), the value of X, the amount of tax shown on the taxpayer's return, cannot be reduced below zero as a result of disallowed refundable credits. The taxpayer at issue in this memo reported a tax liability (X) of . Her correct tax liability (W) was , as were the values of Y and Z. Plugging these values into the 6664 formula yields an underpayment of and, under Rand, this taxpayer's erroneous claim for refund does not alter this calculation. Because no underpayment exists, the section 6662 penalty cannot apply.* However, this taxpayer may be subject to the section 6676 penalty, provided she did not have a reasonable basis for her refund claim.

* Likewise, the section 6663 penalty cannot apply where there is no underpayment. Section 6662A also does not apply in this case because this case does not involve a reportable transaction.

Please contact Sarah McLemore of Procedure and Administration, Branch 2, at (202) 317-5197 if you have any questions regarding this memo.