

**Office of Chief Counsel  
Internal Revenue Service  
Memorandum**

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date: August 19, 2016

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from: Steven Harrison  
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subject: RNB IPG – Additions to Tax or Penalties on Claims for Deficiency Dividends

This Chief Counsel Advice responds to your request for assistance in relation to the above matter, including the memo submitted on March 16, 2016, subsequent correspondence and discussions (together, the “request”). The request relates to the treatment of a regulated investment company (“RIC”) or a real estate investment trust (“REIT”) that files a deficiency dividends deduction claim under section 860 of the Internal Revenue Code (“Code”) and the Income Tax Regulations (“Regulations”) thereunder. This advice may not be used or cited as precedent.

**ISSUES**

- 1) Whether a RIC or a REIT that files a deficiency dividends deduction claim under section 860 is liable for an addition to tax for late filing or failure to pay under section 6651(a)(1) or (2).
- 2) Whether a RIC or a REIT that files a deficiency dividends deduction claim under section 860 is liable for the accuracy-related penalty under section 6662.
- 3) Whether a RIC or a REIT that files a deficiency dividends deduction claim under section 860 is subject to any other addition to tax, additional amount or penalty under Chapter 68 of the Code.

- 4) Whether Letter 105C or 2765C is the appropriate document by which the Service should communicate to a RIC or a REIT that its claim for a deficiency dividends deduction has been denied.
- 5) Whether a RIC or a REIT has appeal rights when the Service denies a claim for a deficiency dividends deduction.

## CONCLUSIONS

- 1) In general, a RIC or a REIT that is allowed a deficiency dividends deduction under section 860(a) is not liable for an addition to tax under section 6651(a)(1) or (2) for failure to timely file a return or timely pay the amount shown on a return.<sup>1</sup>
- 2) In general, a RIC or REIT that is allowed a deficiency dividends deduction under section 860(a) is not liable for any accuracy-related penalty under section 6662 on an underpayment resulting from the deemed increase in tax under section 860(c).
- 3) In general, a RIC or a REIT that is allowed a deficiency dividends deduction under section 860(a) is not liable for any other addition to tax, additional amount or penalty under Chapter 68 of the Code for taxable years beginning after December 22, 2010.
- 4) The Service may use Letter 105C to communicate to a RIC or REIT that its claim for a deficiency dividends deduction was denied or allowed. This memorandum includes comments on the draft documents sent to the national office for review which address, inter alia, filing Form 8927 under Rev. Proc. 2009-28.<sup>2</sup>
- 5) There are ways in which a RIC or REIT might be able to secure administrative review of the denial of a claim for a deficiency dividends deduction. This memorandum briefly discusses avenues for administrative and judicial review below.

## LAW AND ANALYSIS

### **Background**

RICs and REITs usually eliminate or minimize their entity-level income tax liability by paying dividends to their shareholders that are eligible for the dividends paid deduction described in section 561("DPD"). See I.R.C. § 852(b)(2)(D) (allowing DPD for RICs); I.R.C. § 857(b)(2)(B) (allowing DPD for REITs). RICs and REITs are also subject to

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<sup>1</sup> This conclusion assumes that the RIC or REIT timely filed its federal income tax return for the taxable year with respect to which the deficiency dividends deduction is allowed by section 860(a).

<sup>2</sup> See Rev. Proc. 2009-28, 2009-20 I.R.B. 1011 (describing circumstances under which the filing of Form 8927, *Determination Under Section 860(e)(4) by a Qualified Investment Entity*, by a RIC or a REIT is treated as a determination for purposes of section 860(e) and "a statement by the taxpayer attached to its amendment or supplement to a return of tax for the relevant tax year" for purposes of section 860(e)(4)).

minimum distribution requirements to secure the tax benefits of qualifying as a RIC or REIT. See I.R.C. §§ 852(a)(1) and 857(a)(1). The amount of the DPD for a taxable year generally includes the amount of dividends paid during the taxable year. See I.R.C. § 561(a)(1). There are, however, certain provisions under which a dividend paid during one year is taken into account in the DPD for a different year.

#### Deficiency dividends under section 860

Section 860(a) provides the following general rule for deficiency dividends deductions: “If a **determination** with respect to any **qualified investment entity** results in any **adjustment** for any taxable year, a deduction shall be allowed to such entity for the amount of **deficiency dividends** for purposes of determining the [DPD] for such year.” I.R.C. § 860(a) (emphasis added). Section 860(b) defines **qualified investment entity** to mean a RIC or a REIT.

Section 860(e) defines **determination** to include (1) a decision by the Tax Court, or a judgment, decree, or other order by any court of competent jurisdiction, which has become final, (2) a closing agreement made under section 7121, (3) under regulations prescribed by the Secretary, certain other agreements between the Service and the RIC or REIT, and (4) a statement by the taxpayer attached to its amendment or supplement to a tax return for the relevant tax year.

Section 860(d) defines the term **adjustment**<sup>3</sup> by specifying certain changes to amounts that may increase the tax liability of a RIC or REIT (for example, a decrease in the DPD, determined without regard to capital gains dividends).

Under section 860(f), **deficiency dividends** generally are distributions of property by a RIC or REIT that would have been includible in the computation of the DPD for the taxable year for which the determination is made if distributed during that year, subject to requirements of section 860 and section 1.860-2.<sup>4</sup>

Section 860(h)(1) addresses the statute of limitations as follows:

If the [RIC or REIT] files a claim as provided in [section 860(g)], the running of the statute of limitations provided in section 6501 on the making of assessments, and the bringing of distraint or a proceeding in court for collection, in respect of the deficiency established by a determination under this section, and all interest, additions to tax, additional amounts, or

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<sup>3</sup> This term is defined separately: For RICs see section 860(d)(1), for REITs see section 860(d)(2).

<sup>4</sup> Section 860(f)(1), for example, contains timing requirements and requires that the claim described in 860(g) be filed after the payment of the deficiency dividends. Section 860(f)(2) provides limits on the amounts of ordinary and capital gain dividends that may be paid as deficiency dividends in respect of a taxable year. Section 860(f)(3) provides that deficiency dividends are not included in the DPD for the year paid (or for the preceding taxable year under section 855(a) or 858(a)). Under 860(g), no deficiency dividend deduction shall be allowed unless a claim is filed within 120 days of the determination. The form used by a RIC, REIT or personal holding company to file claims for deficiency dividends deductions is Form 976, above.

assessable penalties *in respect thereof*, shall be suspended for a period of 2 years after the date of the determination.

I.R.C. § 860(h)(1) (emphasis added). Section 860(h)(2) provides rules regarding a stay of collection, which provide in part that, in the case of a deficiency established by a determination:

(A) the collection of the deficiency, and all interest, additions to tax, additional amounts, and assessable penalties in respect thereof, shall, except in cases of jeopardy, be stayed until the expiration of 120 days after the date of the determination, and

(B) if claim for a deficiency dividend deduction is filed under subsection (g), the collection of such part of the deficiency as is not reduced by the deduction for deficiency dividends provided in subsection (a) shall be stayed until the date the claim is disallowed (in whole or in part), and if disallowed in part collection shall be made only with respect to the part disallowed.

I.R.C. § 860(h)(2).

In general, under section 860(i), no deficiency dividend deduction is allowed if the determination contains certain findings of fraud or willful failure to timely file an income tax return.

#### Rules for determining Interest, additions to tax, and additional amounts

Section 860(c) contains rules for determining interest, additions to tax, and additional amounts, if any, by reference to the amount of deficiency dividend deduction allowed by section 860(a). Section 860(c)(1) provides in part:

For purposes of determining interest, additions to tax, and additional amounts—

(A) the **tax imposed by this chapter** (after taking into account the deduction allowed by subsection (a)) on the [RIC or REIT] for the taxable year with respect to which the determination is made **shall be deemed to be increased by an amount equal to the deduction allowed by subsection (a)** with respect to such taxable year.

(B) the last date prescribed for payment of such increase in tax shall be deemed to have been the last date prescribed for the payment of tax (determined in the manner provided by section 6601(b)) for the taxable year with respect to which the determination is made, and

(C) such increase in tax shall be deemed to be paid as of the date the claim for the deficiency dividend deduction is filed.

I.R.C. § 860(c)(1) (emphasis added). Section 860(c)(2) provides, in general, that, if a deficiency dividend deduction results in an overpayment, credit or refund shall be made as if, on the date of the determination, 2 years remained before the expiration of the period of limitations on the filing of claim for refund for the year of the overpayment.

Section 1.860-3(a) of the Regulations limits the purposes for which the deemed

increase in tax described in section 860(c)(1)(A) applies:

This deemed increase in tax, however, applies solely for purposes of determining the liability of the entity for interest under subchapter A of chapter 67 of the Code and additional amounts under chapter 68 of the Code.

Treas. Reg. § 1.860-3(a).

Section 6601 provides for interest on certain underpayments, nonpayments and extensions of time for payment, of tax. Section 6601(a) provides:

If any amount of tax imposed by this title . . . is not paid on or before the last date prescribed for payment, interest on such amount at the underpayment rate established under section 6621 shall be paid for the period from such last date to the date paid.

I.R.C. § 6601(a). Therefore, giving effect to the rules of section 860(c)(1), a RIC or REIT allowed a deduction under 860(a) is liable for interest at the underpayment rate on the amount of the deficiency deduction allowed (the deemed increase in tax) from the last date prescribed for the payment of tax for the taxable year affected by the determination (the deemed last date prescribed for payment of the increase) to the date the claim for the deficiency dividend deduction is filed (the deemed payment date).

Prior to its repeal, section 860(j) provided a cross reference to former section 6697. Both of these sections have been repealed. Immediately prior to its repeal, however, former section 860(j) provided: “For assessable penalty with respect to liability for tax of a regulated investment company which is allowed a deduction under [section 860(a)], see section 6697.”

From approximately 1978 until 1986, former section 6697 imposed a penalty on a RIC or a REIT<sup>5</sup> if the RIC or REIT’s tax was deemed increased under section 860(c)(1)(A). The penalty was calculated in an amount equal to the interest for which the entity was liable as a result of the deemed increase in tax, subject to a limitation under which the penalty could not exceed one half of the deficiency dividend deduction. The legislative history associated with section 860 indicates that Congress designed the penalty and interest to discourage the entity from reducing current distributions of income in reliance on the availability of the deficiency dividend procedure to retain its qualified status.<sup>6</sup>

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<sup>5</sup> Amendments to section 6697 initially expanded then narrowed the applicability of this penalty before it was repealed entirely. See footnotes 6 - 8.

<sup>6</sup> The penalty under section 6697 was first enacted by the Tax Reform Act of 1976, P.L. 94-455, 90 Stat. 1520, as part of the deficiency dividends procedures set forth under former section 859, which applied only to REITs. The House of Representatives Ways and Means Committee Report includes the following explanation of the provisions imposing interest and the penalty under what became section 6697:

The interest and penalty provisions of the bill with respect to deficiency dividends are designed to recover lost revenues to the government, but are also intended to assure that a REIT will be operated as a conduit of income to its shareholders and will not fail to distribute income, thereby

S. Rep. 95-1263, at 177 (1978); see also JCS-1-79, *General Explanation*, at 209-210.<sup>7</sup>

The Regulated Investment Company Modernization Act of 2010, P.L. 111-325, § 501(a), 124 Stat. 3537, amended the Code by striking the penalty under section 6697 and the cross reference to the penalty under section 860(j). The amendment is effective for taxable years beginning after December 22, 2010, the date of enactment. The legislative history associated with former sections 6697 and 860(j) suggests that, following the repeal of the additional penalty imposed by former section 6697 and the cross reference to it provided by section 860(j), Congress intended to impose only the interest penalty in the manner set forth under section 860(c) in circumstances under which a RIC or REIT is allowed a deduction for deficiency dividends by section 860(a).<sup>8</sup>

The Service asked whether any of the additions to tax under section 6651 or penalties under Chapter 68 of the Code apply as a consequence of a determination that results in

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unfairly competing with other financial institutions. Under the bill, interest and penalties are imposed on the total amount of the adjustment involved in the determination for the year in question . . . By using the amount of the adjustment as the base, the bill assures that the net cost to the REIT of borrowing money from its shareholders (that is, the net cost of underdistributions) is high enough to discourage such action and to encourage the distribution of earnings to shareholders currently.

H.R. Rep. No. 94-658, at 356 (1975). The companion Senate Finance Report contained a similar explanation of the proposed penalty and also expressly stated that the penalty was aimed at discouraging a REIT from reducing distributions of income in reliance on the availability of the deficiency dividend procedure. S. Rep. No. 94-938, at 465 (1977). The Senate Finance Committee Report provides further:

Under the committee amendment, interest on the amount of the deficiency dividend is to run from the last day (without extensions of time) for the REIT to file a tax return for the year in question until the date the claim for the deficiency dividend deduction is filed. In addition a nondeductible penalty equal to the amount of interest is to be paid. However, the total penalty is not to exceed on-half of the amount of the deficiency dividend deduction. Under the committee amendment the (deductible) interest charge is to be the same as in the case of other deficiencies and the penalty is to be the same amount, for an approximate net-after-tax total of 10 ½ percent of the deficiency dividend deduction per annum.

Id at 466. Under the Revenue Act of 1978, P.L. No. 95-600, § 362(b), 92 Stat. 2763, Congress amended the Code to make the deficiency dividends procedures applicable to both RICs and REITs under new section 860.

<sup>7</sup> The Tax Reform Act of 1986, P.L. 99-514, § 667, 100 Stat. 2085, removed REITs from this penalty by, amending sections 6697 and 860(j) by, *inter alia*, striking out the term “qualified investment entity” where it appeared under these sections and inserting in lieu thereof the term “regulated investment company”.

<sup>8</sup> JCS-2-11, at 687; JCX-49-10, at 34; H.R. 4337, Ways and Means Committee Summary of H.R. 4337, “*Regulated Investment Company Modernization Act of 2010*”, Sept. 28, 2010, at 7 (bill would conform the RIC and REIT deficiency dividend rules and repeal the additional penalty applicable to RICs making deficiency dividend); Ways and Means Committee Summary of H.R. 4337, “*Regulated Investment Company Modernization Act of 2010*” (House passed Senate Amendment), December 15, 2010 (bill conforms RIC and REIT deficiency dividend rules and repeals additional penalty on a RIC making a deficiency dividend).

an adjustment for the taxable year. To clarify the request, the mere filing of Form 976 by a RIC or a REIT does not give rise to tax liability or additions to tax. The deemed increase in tax for a taxable year described in section 860(c) is in an amount equal to the amount of the deduction *allowed* by section 860(a) for that taxable year.

As a preliminary matter, section 860 does not directly impose a penalty or preempt the imposition of a penalty. Instead section 860(c) specifies rules for applying interest and additions to tax imposed by other provisions. For example, as discussed above, interest under section 6601 applies not because section 860(c) mentions section 6601, but because the terms of section 6601(a) are broad enough to apply to an underpayment arising from the deemed increase in tax imposed in section 860(c). When in effect for the relevant type of entity (RIC or REIT), former section 6697 applied to the deemed increase under section 860(c)(1)(A), because it expressly stated that it applied.

For a RIC or REIT that is allowed a deficiency dividend deduction, Congress appears to have intended that the relevant penalty would ordinarily consist of interest under section 6601 in the amount determined under section 860(c) and, when applicable, the penalty that was imposed under former section 6697. Whether any other additional penalties apply to a deemed increase in tax under section 860(c), however, depends on the terms of the provision imposing the penalty and all of the facts and circumstances. Therefore, the terms of different penalties must be considered individually.

The following sections discuss specific provisions that impose additions to tax or penalties. There is not a separate analysis of each provision to determine whether it applies to any amount of tax for which a RIC or REIT would be liable but for the allowance of a deficiency dividends deduction, because none of them applies to such amount. I.R.C. § 860(a) (allowing the deduction); I.R.C. § 860(c) (giving effect to the deduction before creating a deemed increase in tax); Treas. Reg. § 1.860-3(c) (Example 1) (explaining that a REIT is “not subject to interest and penalties for the amount of any tax for which it would have been liable” under specified provisions).

### **Issue 1: Additions to tax under section 6651(a)(1) and (2)<sup>9</sup>**

The addition to tax under section 6651(a)(1), applicable when a taxpayer fails to file a return by the required deadline, is imposed in an amount equal to 5 percent of “the amount required to be shown as tax on such return” for each month, or fraction of a month, during which the return is not filed, not to exceed 25 percent in the aggregate.

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<sup>9</sup> The request also mentions the addition under section 6651(a)(3), which applies when the taxpayer fails to pay the amount of tax required to be shown on a return within 21 days of the Service sending a notice of assessment and demand for payment. The situation described in the request does not implicate section 6651(a)(3); the request focuses on the pre-assessment procedures and whether a RIC or REIT is subject to one or more of the Code’s penalties when there is a “determination” under section 860(e). As a result, we do not discuss section 6651(a)(3).

Because the fact pattern described in the request does not involve a late filed return<sup>10</sup> by a RIC or a REIT, the addition to tax under section 6651(a)(1) does not apply. Additionally, because the Form 976 on which the taxpayer makes a claim for a deficiency dividend deduction is not a *return*, as contemplated by section 6651(a) or the test used by the courts for a valid return,<sup>11</sup> the addition under section 6651(a)(1) for late filing is not implicated.

The addition to tax under section 6651(a)(2) applies when there is a “failure . . . to pay **the amount shown as tax** on any return specified in paragraph (1) . . . .” I.R.C. § 6651(a)(2) (emphasis added). A taxpayer is liable for this addition when he files a return showing a balance due but fails to pay it on the last day prescribed for payment. *Candy’s Tortilla Factory v. United States*, 97-2 U.S. Tax Cas. (CCH) P50,779 (D. Colo. 1997). The Service and courts interpret the phrase “**amount shown as tax** on [the] return” in this addition to tax to mean the amount the taxpayer lists on his return as his tax liability for the year. Treas. Reg. § 301.6651-1(f) (*Example (2)*); *Voccola v. Commissioner*, T.C. Memo. 2009-11 (taxpayer was not liable for the addition to tax under section 6651(a)(2) because he listed \$0 as total tax on his return; Service erred in applying failure to pay addition to deficiency amount); *Smith v. United States*, 571 F.Supp. 664, 666 (S.D.N.Y. 1983) (“[u]pon failure to pay the amount shown on a return, § 6651(a)(2) separately provides that a .5% penalty shall be assessed upon the taxpayer for each unpaid month”).

The “amount shown as tax” on a filed tax return, which is the language chosen by Congress for section 6651(a)(2), is clearly distinguishable from “the tax imposed by this chapter” under section 860(c)(1)(A). We located no reported case in which a court interpreted the meaning of “tax imposed by this chapter” under section 860(c)(1)(A). The Service interprets the phrase “tax imposed” in other contexts to mean the correct tax liability of the taxpayer for the taxable period. See, e.g., Treas. Reg. §§ 301.6211-1(e) (*Example 1* illustration of definition of deficiency) and 1.6664-2(b) (“amount of income tax imposed” defined for purposes of calculating underpayment to which accuracy-related penalty applies). Because these phrases have different meanings under the Code, a court is unlikely to construe the deficiency dividend provisions to mean that “tax imposed” and “amount shown as tax” on a return have the same meaning when applied to determine whether a RIC or a REIT making a deficiency dividend distribution is liable for an addition to tax or penalty. Consequently, the addition to tax under section 6651(a)(2) for failure to pay is not applicable in this situation.

## **Issue 2: Accuracy-related penalty under section 6662**

The accuracy-related penalty under section 6662, also within Chapter 68, is calculated

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<sup>10</sup> To file its federal income tax return for a taxable year, a REIT is required to file Form 1120-REIT, and a RIC is required to file Form 1120-RIC.

<sup>11</sup> *Beard v. Commissioner*, 82 T.C. 766 (1984), *aff’d.*, 793 F.2d 139 (6th Cir. 1986).



as 20% of the portion of “an underpayment of tax required to be shown on a return” that is attributable to negligence or disregard of rules or regulations, a substantial understatement of tax, a substantial valuation misstatement, or any of the other causes listed in section 6662(b). “Underpayment,” in turn, is defined by section 6664(a) as:

the amount by which any *tax imposed by this title* exceeds the excess of—

(1) the sum of—

(A) the amount shown as the tax by the taxpayer on his return, plus

(B) amounts not so shown previously assessed (or collected without assessment),  
over

(2) the amount of rebates made.

I.R.C. § 6664(a) (emphasis added). The implementing regulation for this definition defines the amount of *tax imposed* as the amount of tax imposed on the taxpayer under subtitle A for the taxable year, except that the term does not include credits for tax withheld, payments of estimated tax and other items not relevant here. Treas. Reg. § 1.6664-2(b). Because section 860(c)(1)(A) deems the amount of *tax imposed* upon a RIC or a REIT to be increased when a deficiency dividend is allowed, it follows that the “tax imposed” for purposes of calculating an underpayment—a term included among the penalties in Chapter 68—is also increased. Thus, the deemed increase in tax described in section 860(c) may give rise to an underpayment under section 6664. This conclusion is also consistent with the conclusion that interest under section 6601 applies.

Section 6662, however, applies only to an “underpayment of tax required to be shown on a return.” The deemed increase in tax described in section 860(c) is not an amount of tax required to be shown on a return. It is a fictional amount of tax used solely for computing interest and penalties and cannot be read as reversing or disregarding the deduction under 860(a). The deduction under section 860(a) is a decrease in *taxable income*, while section 860(c) creates a deemed increase in *tax*. Accordingly, the amount of any underpayment that results does not correspond to the amount of the underpayment that would exist had the RIC or REIT not been allowed a deficiency dividend deduction. Section 860(c) contains a deemed amount, a deemed due date, and a deemed payment date, which are sufficient to determine the intended interest and additions to tax under section 6601 and former section 6697. Section 860(c) does not deem a return on which the deemed increase in tax is required to be shown. Moreover, section 860(c) does not deem there to be negligence, a substantial understatement, or any other fact that would cause section 6662 to apply. Accordingly, the penalty under section 6662 should not apply to any underpayment arising from the deemed increase in section 860(c).

The analysis differs with respect to an underpayment arising from an actual increase in tax liability that results from a determination and that is *not* eliminated with a deficiency dividends deduction. Whether an accuracy-related penalty would apply to such an underpayment generally would be determined on the basis of the facts and circumstances giving rise to the determination. If the Service seeks to assert the

penalty against a RIC or REIT that makes a determination by filing Form 8927, however, it should consider the possibility that the determination constitutes a qualified amended return under section 1.6664-2(c)(3). The additional tax reported on a qualified amended return is treated as shown on the return and has the practical effect of negating the underpayment upon which the accuracy-related penalty is based. Treas. Reg. § 1.6664-2(c)(2) and (3).

### **Issue 3: Other additions to tax and penalties**

#### Failure by corporation to pay estimated income tax

Because one of the components of the addition to tax under section 6655 (“estimated tax penalty”) is expressly tied to the “*tax shown on the return*” by the taxpayer, this addition is unlikely to apply to a RIC or a REIT in connection with a determination and allowed deduction for deficiency dividends under section 860. The following is a summary of the relevant portions of section 6655.

If a corporation anticipates tax due of \$500 or more for the taxable year, it must estimate its tax liability for the current year and pay four quarterly estimated tax installments during the year. I.R.C. § 6655. Section 6655(a) imposes an addition to tax on a corporation which underpays estimated tax for the year. The addition is determined by applying:

- (1) the underpayment rate established under section 6621,
- (2) to the amount of the underpayment,
- (3) for the period of the underpayment.

I.R.C. § 6655. Section 6655(b)(1) defines “amount of the underpayment” as “the excess of (A) the required installment, over (B) the amount (if any) of the installment paid on or before the due date for the installment.” The “required installment” is 25 percent of the “required annual payment.” I.R.C. § 6655(d)(1)(A). “Required annual payment” means the lesser of:

- (i) 100 percent of the *tax shown on the return for the taxable year* (or if no return is filed, 100 percent of the tax for such year), or
- (ii) 100 percent of *the tax shown on the return* of the corporation for the preceding taxable year.

I.R.C. § 6655(d)(1)(B)(i) and (ii) (emphasis added).<sup>12</sup>

Because the “required annual payment” is calculated by reference to the “tax shown on the return” of the corporation for the year, the statutory language of section 6655 does not appear to support the position that a RIC or a REIT is subject to this addition to tax when a section 860 determination is made and a deficiency dividend deduction is

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<sup>12</sup> A large corporation may not use the tax shown on its return for the preceding taxable year in calculating the “required annual payment” for the current year. § 6655(d)(2)(A).

allowed. The Service would have to argue that the RIC or REIT's "required annual payment" for the year under section 6655(d)(1)(B) is increased by the amount of the allowable deficiency dividend deduction. As noted previously, section 860(c) deems the "tax imposed by this chapter," rather than the "tax shown on the return," to be increased by an amount equal to the deduction allowed.

#### Penalty for excessive claim for credit or refund

Section 6676 imposes a 20% penalty against a taxpayer which makes a claim for credit or refund in an excessive amount, unless it is shown that there was reasonable cause for the claim. The phrase "excessive amount" means the amount by which the claim for credit or refund for the taxable year exceeds the amount of the claim allowable under the Code. I.R.C. § 6676(b). We included this brief discussion of this penalty primarily because the allowance of a deduction for deficiency dividends in some instances results in an overpayment of tax. Treas. Reg. § 1.860-4. The RIC or a REIT seeking a refund is required to make a claim on Form 1120X. *Id.* A RIC's or REIT's liability for this penalty will depend upon the merits of the refund claim included with Form 1120X and, assuming the claim is disallowed, whether the entity can establish reasonable cause for making the excessive claim. Because refund claims by RICs and REITs are not mentioned in the request and were not among the supplemental issues raised by the Service, we do not discuss this further.

#### **Issue 4: Comments on documents**

Below are comments on each of the draft documents submitted for Counsel's review as attachments to the email of April 28, 2016.

#### Draft IRM 21.7.4 procedures

In regard to the question posed in connection with proposed IRM 21.7.4.4.4.11.12.2(3), as noted above, the addition to tax under section 6651(a)(3) does not apply in this context.

Proposed IRM 21.7.4.4.4.11.12.2(5) includes five events, each designated with a bullet point, which a taxpayer must satisfy before a Form 976 (claim for deficiency dividend deduction) is considered to be timely filed. The fourth bullet in this paragraph reads:

"Form 8927 was filed on or before the ASED for the subject year."

We suggest that the above bullet point be removed from the proposed IRM provision. This is not a requirement for timely filing Form 8927 or Form 976 under section 860, the regulations thereunder, or Rev. Proc. 2009-28, 2009-20, I.R.B. 1011. See sections 2.08 – 2.11 of Rev. Proc. 2009-28 for general guidance regarding timely filing Form 8927.

As to the whether the two-year suspension of the running of the statute of limitations

described in section 860(h)(1) applies for all purposes, or, instead, is limited to amounts arising from the claim for deficiency dividends deduction, the statutory language “in respect thereof” makes clear that the two-year suspension described in section 860(h)(1) is limited to amounts arising from the claim for deficiency dividends deduction.

#### Draft 3064C letter

We have no comments or suggested revisions.

#### Draft 105C rejection letter

As to the question raised of whether a claim for a deficiency dividend deduction is a “claim”, section 860(g) clearly states that a RIC or a REIT seeking a deduction for a deficiency dividend must file a “claim.” The Service can use Letter 105C with language tailored toward a claim for a deficiency dividend deduction. The Service should ensure that the particular form letter used to communicate with taxpayers does not erroneously mention the 2-year limitation period on commencing a lawsuit for a refund or credit of an internal revenue tax, which applies following the issuance of a notice of claim disallowance. I.R.C. § 6532(a)(1).<sup>13</sup> Generally speaking, the most common use of “claim” arises in connection with claims for refunds (or credits) of internal revenue taxes.

For reasons set forth above in our discussion of the proposed IRM provisions in reference to the fourth bullet point, we suggest that you strike paragraph (c).<sup>14</sup> Otherwise, we have no comments or corrections to the body of the remaining paragraphs in this draft letter.

#### **Issue 5: Administrative review**

Because there are numerous ways in which a RIC or a REIT could secure administrative and judicial review in connection with the deficiency dividend deduction provisions, our office would prefer to opine on this topic in response to more fact-specific questions. For purposes of this memorandum, we discuss two situations, one involving no overpayment of tax and another entailing an overpayment.

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<sup>13</sup> We mention this because one of the principal uses of the Letter 105C by the Service is for communicating refund claim disallowances to taxpayers.

<sup>14</sup> Paragraph (c) of the draft letter provides, as follows:

(c) Your Form 976 must generally be filed by [Insert ASED date] MM/DD/YYYY, which is 3 years of when your Form [Insert the form number] 1120-RIC or 1120-REIT was filed. The deadline is suspended for 2 years if your Form 8927 was filed on or before that date.

However, the postmark date on your Form 8927’s envelope is [Insert date] MM/DD/YYYY, so the deadline wasn’t suspended. We can’t allow your claim because your Form 976 wasn’t filed before the deadline.

Assume that a taxpayer, a RIC or REIT, discovers errors in its previously filed Form 1120 and makes a determination by filing Form 8927. Also assume that the taxpayer makes timely distributions of property to shareholders but that these would not qualify for the dividends paid deduction, as described in Treas. Reg. § 1.860-2(a)(3). If the Service later denies the taxpayer's claim for a deficiency dividend deduction, it should follow that the Code's deficiency procedures apply. In this situation, the taxpayer may receive a 30-day letter and have the opportunity to file a protest before Appeals and secure judicial review after the issuance of a notice of deficiency.

A RIC or a REIT that files a Form 976 and amended Form 1120 showing an overpayment and claim for refund as a result of the payment of the deficiency dividend will have its claim administratively considered by the Service. If the Service denies the refund claim, the taxpayer will have the right to initiate a civil refund action in the appropriate district court or the Court of Federal Claims.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call Roger E. Wade, (202) 317-4526, if you have any further questions.