

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

CC:PA:02:JQueener  
PRENO-119576-14

date: August 6, 2014

to: Florence Adamson  
Chief Discretionary Exam & Innocent Spouse

from: Ashton P. Trice  
Chief, Branch 2  
Procedure and Administration

---

subject: Section 6676 Penalty

This memorandum responds to several questions that you asked us about the section 6676 penalty.

**Issues:**

1. Does the IRC section 6676 penalty apply to refund claims made on Form 1040 and Form 1040X and does it matter whether the Service has paid the claim?
2. Does the nature of the item to which the excessive amount is attributable have any bearing on the penalty?
3. Is the section 6676 penalty subject to deficiency procedures?
4. Are there any specific taxpayer notifications required for the penalty to apply?
5. Does the 'reasonable basis' exception to the section 6676 penalty have the same general meaning as the reasonable basis exception to negligence found in Treas. Reg. 1.6662-3(b)(3)?

**Conclusions:**

1. A section 6676 penalty may apply to a refund claim made on a Form 1040 only when that refund claim is based on erroneously-claimed refundable credits other than the Earned Income Credit. This is so regardless of whether the Service has paid the refund claimed on the original return.

When erroneous claims for refund or credit are made on amended returns, the section 6676 penalty may apply if the refund or credit claimed is not paid or allowed. If the refund or credit is paid or credited to the taxpayer and is later determined to be

erroneous, a section 6676 penalty may apply only if the refund claim is based on erroneously-claimed refundable credits other than the Earned Income Credit. Otherwise, an underpayment will result and will be subject to a section 6662 or 6663 penalty. If the limitations period on assessing a penalty on the underpayment has expired, however, the section 6676 penalty may apply.

2. The nature of the item resulting in an excessive amount claimed will make a difference as to whether the section 6676 penalty applies. If the item is a reportable transaction, the section 6662A penalty rather than a section 6676 penalty applies. If the item results in an underpayment, a penalty under section 6662 or 6663 applies rather than section 6676. If the excessive amount relates to the earned income credit (EIC) under section 32, the section 6676 penalty does not apply. If the claim for an excessive amount has a reasonable basis, the section 6676 penalty does not apply, but an excessive amount attributable to a transaction lacking economic substance never has a reasonable basis.

3. As a rule, penalties are assessable without deficiency procedures when they are not dependent upon the determination of a deficiency. When an excessive amount is attributable to a disallowed refundable credit, the disallowed credit is part of a deficiency determination and subject to deficiency procedures. Under the general rule, the section 6676 penalty should also be subject to deficiency procedures. In all other cases, the section 6676 penalty is assessable without following deficiency procedures.

4. Section 6676 itself does not require any specific taxpayer notification requirements.

5. Reasonable basis under section 6676 has the same general meaning as that term is defined in Treas. Reg. § 1.6662-3(b)(3).

## **Law and Analysis:**

### **A. Application of the Section 6676 Penalty**

Generally, section 6676 imposes a 20 percent penalty on the excessive amount of a claim for refund or credit that lacks a reasonable basis. The statute, however, carves out a few exceptions to this general rule.

Section 6676 does not apply to an excessive amount 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. The section 6662A reportable transaction understatement penalty can exist only when there is a reportable transaction reflected on a return. That situation will be relatively uncommon. The section 6662 or 6663 penalty can exist only when there is an underpayment as defined in section 6664(c).

The section 6664 regulations define 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 previously assessed (or collected without assessment), over (B) the amount of rebates made. Treas. Reg. §1.6664-2(a). An underpayment can be expressed as equal to  $W - (X + Y - Z)$  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 previously assessed (or collected without assessment); and  $Z$  is the amount of rebates made. Id.

An erroneous refund claim made on an original return (a Form 1040) will generally result in an underpayment regardless of whether a refund is paid. When a refund is attributable to refundable credits erroneously claimed, the excessive amount claimed does not enter into the calculation of  $X$ , the amount shown as the tax on the taxpayer's return, and the underpayment does not include the amount of the erroneous refund. See Rand v. Commissioner, 141 T.C. No. 12 (2013). As a result, the section 6676 penalty may apply to a refund claim on a Form 1040 to the extent that the refund claim is based on a refundable credit other than the EIC and does not have a reasonable basis.

If a taxpayer makes a claim for refund or credit after filing an original return and the Service pays the refund, an underpayment generally will arise because  $X$ , the amount shown as the tax on the taxpayer's return will be smaller so long as the refund is not based on a refundable credit. If the refund claim is based on a refundable credit, the section 6676 penalty may apply to the extent that the refund claim is not based on the EIC and does not have a reasonable basis.

If the taxpayer makes an erroneous claim for refund or credit on an amended return and the Service does not pay the refund, an underpayment generally will not arise. This is arguably for either of two reasons: (1) the amended return can be considered rejected, in which case, the figures for  $W$ ,  $X$ ,  $Y$  and  $Z$  do not change or, (2) alternatively, one might view  $X$ , the amount shown as tax on the taxpayer's return, as being reduced and  $Y$ , the amount not so shown previously assessed (or collected without assessment), as being increased in the same amount that  $X$  was reduced. In the latter view, the changes to  $X$  and  $Y$  will cancel each other out and not alter the underpayment. Because no underpayment results from the unpaid refund claim on the amended return, the section 6676 penalty may apply.<sup>1</sup>

## **B. Application of the Penalty**

The nature of the item resulting in an excessive amount claimed can make a difference in the applicability of the penalty. If the excessive amount is attributable to a reportable

---

<sup>1</sup> If an underpayment arises from an amended return, but the limitations period on assessing a penalty on the underpayment has expired, the section 6676 penalty arguably applies so long as any limitations period applicable to its assessment has not expired.

transaction, a section 6662A penalty applies and the section 6676 penalty cannot apply.<sup>2</sup> See I.R.C. § 6676(d).

As the discussion of issue 1 shows, if the excessive amount is part of an underpayment, then the section 6676 penalty cannot apply. Even if the excessive amount is not part of an underpayment because it is based on a refundable credit, it is not subject to a section 6676 penalty if the refundable credit at issue is the earned income credit under section 32. I.R.C. § 6676(a) expressly carves out the earned income credit from the penalty. Similarly, the penalty does not apply if the taxpayer shows that there was a reasonable basis for the excessive amount claimed. If the excessive amount is attributable to a transaction lacking economic substance, however, it cannot be treated as having a reasonable basis. I.R.C. § 6676(c).

### **C. Deficiency Procedures**

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 penalty only when the excessive amount subject to penalty is attributable to a refundable credit.

Section 6671, which appears in Subchapter B of Chapter 68 along with section 6676, states that the penalties provided by that subchapter shall be paid upon notice and demand, and shall be assessed and collected in the same manner as taxes. It further states that, except as otherwise provided, any reference in the Code to “tax” imposed by the Code is deemed to refer to the penalties set forth in Subchapter B. Likewise, section 6665(a) states that the additions to tax, additional amounts, and penalties provided by Chapter 68 shall be paid upon notice and demand and shall be assessed, collected, and paid in the same manner as taxes, again with “tax” referring to the tax, additional amounts, and penalties provided by Chapter 68. Some taxes, such as income taxes, are subject to deficiency procedures. Other taxes, such as employment taxes, are not subject to deficiency procedures. Therefore, there is no one procedure to assess taxes that apply to all penalties.

In interpreting section 6671 and 6665, the Tax Court has applied a rule that, when a penalty is dependent upon the determination of a deficiency, then the penalty is 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

---

<sup>2</sup> If the reportable transaction is on an amended return that is not accepted, then the section 6662A penalty does not apply because it is calculated from the taxpayer’s return of tax and an unaccepted, amended return would not qualify as the taxpayer’s return of tax. In that case, the section 6676 penalty could apply to an excessive amount based on a reportable transaction.

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.”)

When a disallowed refund on an original return is based on a refundable credit, that portion of the refundable credit will not be part of an underpayment. Rand v. Commissioner, *supra*. It will be part of a deficiency determination, however. *Id.*; see also I.R.C. § 6211(b)(4). Because the disallowed refundable credit is part of a deficiency determination, the section 6676 penalty can apply to the refundable credit only if the Tax Court agrees that there is a deficiency. If the court were to conclude that there is no deficiency, the refundable credit would be allowed and there would be no excessive amount of a refund claim to which the section 6676 could apply. Therefore, in the case of its application to a refundable credit (other than EIC), a section 6676 penalty is subject to deficiency procedures because it is dependent upon the outcome of a petition of the statutory notice of deficiency to Tax Court.

In all other cases in which the section 6676 penalty is applicable, the penalty is not dependent on the determination of a deficiency. Accordingly, the penalty is assessable without deficiency procedures when an excessive amount of a claim for credit or refund arises from an item or transaction other than an erroneous refundable credit.

#### **D. Taxpayer Notifications**

Section 6676 does not impose any requirement to provide a notification to a taxpayer. Of course, if deficiency procedures apply to the penalty, as described above, a statutory notice of deficiency must be sent to the taxpayer. Also, it has been the Service's practice to provide administrative appeal rights prior to assessment of the section 6676 penalty. See IRM sec. 8.11.1.2.7(4). Notice of these rights should be provided to taxpayers.

#### **E. Reasonable Basis**

Section 6676 uses, but does not define, the term “reasonable basis.” That same term appeared, but was also not defined, in section 6662(d)(2)(B)(ii)(II) when it was added to the Code by the Omnibus Budget Reconciliation Act of 1993, Pub. L. 103-66, sec. 13261(g), 107 Stat. 540. The Service then promulgated regulations under the section 6662 (sec. 1.6662-4(e)(2)(i), cross-referencing sec. 1.6662-3(b)(3)) to define the term “reasonable basis” for purposes of that penalty.<sup>3</sup> Because the section 6676 penalty was intended to supplement the section 6662 penalty, among others, adopting the definition of “reasonable basis” from the section 6662 penalty appears appropriate. There is no

---

<sup>3</sup> “Congress has delegated to the Commissioner \* \* \* the task of prescribing all needful rules and regulations for the enforcement of the Internal Revenue Code.” United States v. Correll, 389 U.S. 299, 307 (1967).

apparent reason why avoidance of the section 6662 negligence or substantial understatement penalties on grounds of the taxpayer having a “reasonable basis” should be different than the “reasonable basis” grounds for avoiding the section 6676 erroneous claim for refund penalty. Alt. Cleaners & Dryers, Inc. v. United States, 286 U.S. 427, 433 (1932) (“Where the same words or phrase appear within a text, they are presumed to have the same meaning”).<sup>4</sup>

Please contact Jaqueline Queener of Procedure & Administration, Branch 2, at (202) 317-6844, if you have any questions regarding this memo.

---

<sup>4</sup>

