

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

CC:PA:01: GSemasek
POSTN-125498-10

UILC: 6662.00-00, 6664.01-00, 6676.00-00

date: August 27, 2010

to: Joyce Spence
Acting Supervisory Program Analyst
(Examination Policy, Campus Reporting Compliance SB/SE)

from: Blaise G. Dusenberry
Senior Technician Reviewer, Branch 1
(Procedure & Administration)

subject: Application of IRC section 6662(d) and 6676 to First-Time Homebuyer Credit Cases

This memorandum responds to your request for assistance dated June 11, 2010. This advice may not be used or cited as precedent.

ISSUE

When should the Service apply the accuracy-related penalty based on a substantial understatement of tax, the erroneous claim for refund or credit penalty under section 6676, or both, if the Service determines that the taxpayer is not entitled to a first-time homebuyer credit?

CONCLUSION

The Service should apply the accuracy-related penalty to cases when the taxpayer's request for a refund or credit based on the first-time homebuyer credit (FTHC) results in an underpayment. If an underpayment is present, the erroneous claim for refund or credit penalty under section 6676 does not apply.

If the taxpayer's filing position on his return includes a claim for refund or credit but does not result in an underpayment, the section 6676 penalty applies to the excessive amount of the claim.

Below, this memorandum determines the appropriate penalty for the examples submitted in your request. We have also included brief discussions of the examples included in the memorandum dated November 20, 2009, which deals with the first-time homebuyer credit and the accuracy-related penalty.

PMTA 2011-03

FACTS

SB/SE Campus Compliance Services, Examination Policy seeks additional guidance to supplement the memorandum dated November 20, 2009 to John Caggiano, regarding the accuracy-related penalty, and the memorandum dated March 30, 2010, from this office to Mark Howard respecting the section 6676 penalty and Form 1099-OID schemes. You are seeking guidance on when to apply the accuracy-related penalty under section 6662 and the penalty authorized by section 6676 for excessive claims for credits or refunds. This request includes 3 examples for which you would like to know the appropriate penalty. Additionally, you requested a determination of the correct penalty assertion in each of the examples discussed in the November 20, 2009 memorandum. Finally, you asked that we identify any other penalties that apply to each of the situations presented.

LAW AND ANALYSIS

The memoranda mentioned above discuss the accuracy-related penalty of section 6662 and the penalty for excessive claims for credit or refund under section 6676. As a result, complete descriptions of these penalties are not repeated in full here. The key to identifying which of the penalties applies to a taxpayer erroneously claiming a refund or credit is to first determine if his reporting creates an underpayment on his return.¹

¹ The operative language in the section 6662 accuracy-related penalty includes the term “underpayment,” while the penalty for erroneous refunds or credits in section 6676 does not:

Sec. 6662. Imposition of Accuracy-Related Penalty on Underpayments

(a) Imposition of Penalty. – If this section applies to any portion of an underpayment of the tax required to be shown on a return, there shall be added to the tax an amount equal to 20 percent of the portion of the underpayment to which this section applies . . .

(b) Portion of Underpayment to Which Section Applies. – This section shall apply to the portion of any underpayment which is attributable to 1 or more of the following . . .

* * *

Sec. 6676. Erroneous Claim for Refund or Credit.

(a) Civil Penalty. – If a claim for refund or credit with respect to income tax (other than a claim for a refund or credit relating to the earned income credit under section 32) is made for an excessive amount, unless it is shown that the claim for such excessive amount has a reasonable basis, the person making such claim shall be liable for a penalty in an amount equal to 20 percent of the excessive amount . . .

(b) . . . the term “excessive amount” means . . . the amount by which the claim for refund or credit for any taxable year exceeds the amount of such claim allowable . . .

(c) Coordination with Other Penalties. - This section shall not apply to any portion of the excessive amount of a claim for refund or credit which is subject to a penalty imposed under part II of subchapter A of chapter 68. (emphasis added).

If the Service determines that the taxpayer's reporting on his return results in an underpayment, as defined under section 6664, the section 6662 accuracy-related or section 6663 fraud penalty applies. If either of these penalties applies to the particular tax year at issue, the section 6676 penalty for making a claim for an excessive refund or credit does not apply. I.R.C. § 6676(c)(coordination provision).²

The following is a discussion of the appropriate penalty, if any, applicable to the examples submitted with this request.

Example 1 – The taxpayer reported the following amounts on his Form 1040 for the 2008 taxable year:

Line 43 Taxable Income	\$ (4,500)
Line 44 Tentative Tax	\$ 0
Line 57 Self-employment Tax	\$ 2,100
Line 61 Total Tax Liability	\$ 2,100
Line 62 Federal Tax Withholding	\$ 0
Line 64a Earned Income Credit (EITC)	\$ 4,800
Line 66 Additional Child Tax Credit	\$ 600
Line 69 First-time Homebuyer Credit	\$ 7,500
Line 70 Recovery Rebate Credit	\$ 300
Line 73a Refund Amount	\$11,100

The Service determined that the taxpayer is not entitled to the dependent exemptions claimed, the EITC, and Additional Child Tax Credit. Moreover, the taxpayer is entitled to only one half of the first-time homebuyer credit, which results from a filing status change to married filing separate. After reviewing this return and making adjustments, the Service determines the total tax (a/k/a tax imposed) to be \$13,600, rather than \$2,100.

Is there an underpayment?

The starting point for analyzing this situation is to consider whether the taxpayer's reporting produced an underpayment. Section 6664's definition of

The legislative history accompanying enactment of the section 6676 penalty for erroneous refund or credit claims is consistent with the statutory language of subsection (c): “. . . [t]he penalty does not apply to any portion of the disallowed portion of the claim for refund or credit relating to the earned income credit or any portion of the disallowed portion of the claim for refund or credit that is subject to accuracy-related or fraud penalties. Staff of the Joint Committee on Taxation, Technical Explanation of the Small Business and Work Opportunity Act of 2007 and Pension Related Provisions Contained in H.R. 2206 as considered by the House of Representatives on May 24, 2007, 36 (JCX-29-07).

² See footnote 1 above (coordination provision in I.R.C. § 6676(c)) and IRM 20.1.5.3.2(6) (“Stacking of the 6662, 6663, 6662A and 6676 penalties is not permitted.”).

underpayment applies to the accuracy-related and fraud penalties in sections 6662 and 6663. The regulation expresses this definition as: underpayment = $W - (X+Y-Z)$, where W is the amount of income tax imposed³, X is the amount shown as the tax by the taxpayer on his return,⁴ Y is amounts not so shown previously assessed (or collected without assessment),⁵ and Z is the amount of rebates made.⁶

Application of this regulatory formula to the facts presented results in the following:

³ Under the regulation, the *amount of income tax imposed* is the correct tax, determined *without regard to*: (A) the credits for tax withheld on wages at the source under section 31 and tax withheld at the source on amounts payable to nonresident aliens and foreign corporations under section 33, (B) payments of estimated tax by the taxpayer; (C) any credit resulting from amounts collected as a consequence of a termination or jeopardy assessment, and (D) any tax the taxpayer is not required to assess on the return (e.g. the tax imposed by section 531 on the accumulated taxable income of a corporation). Treas. Reg. § 1.6664-2(b).

The Service interprets this regulation to mean that “amount of income tax imposed” is determined *with regard to* allowable credits, other than those noted in (A)-(D) in the prior paragraph.

⁴ Under Treas. Reg. § 1.6664-2(c), *amount shown as tax by the taxpayer on his return* is the tax reported by the taxpayer on his return (determined without regard to any credits for withholding tax, estimated tax payments or collected sums resulting from a termination or jeopardy assessment), less the amount of any overstated credit for withholding tax on wages or overstated withholding of tax at source on a nonresident alien or foreign corporation.

In calculating the amount shown as the tax by the taxpayer on his return, the Service also reduces the sum the taxpayer reported as tax by the credits he claimed, *including the full amount of incorrectly claimed credits*, but not including credits for withholding tax, estimated tax payments or collected sums resulting from a termination or jeopardy assessment.

⁵ The term *amount not so shown previously assessed (or collected without assessment)* consists of two parts: (1) the amounts not so shown but which were previously assessed and (2) the amounts not so shown as previously assessed collected without assessment. The amounts not so shown but previously assessed means the amounts assessed before the return was filed that were not shown on the return (e.g. termination or jeopardy assessments). The amounts so shown as previously collected without assessment is the amount by which: 1) the sum of (credits allowable for tax withheld on wages + credits allowable for tax withheld at the source + estimated tax payments + other payments made in satisfaction of the liability before the return was filed) exceeds 2) the tax shown on the return (provided the excess has not been refunded or allowed as a credit to the taxpayer) Treas. Reg. § 1.6664-2(d).

⁶ The term *Amount of Rebates Made* for purposes of I.R.C. § 6664 means so much of an abatement, credit, refund or other payment, as was made on the ground that the tax imposed was less than the excess of (1) the sum of (the amount shown as the tax by the taxpayer on his return + the amounts not so shown previously assessed [or collected without assessment]), over (2) the rebates previously made. Treas. Reg. § 1.6664-2(e).

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W	amount of income tax imposed under subtitle A		\$13,600 ⁷
X	amount shown as tax by the taxpayer on his return (line 61 less credits claimed)	(\$11,100) ⁸	
Y	amount not shown previously assessed (or collected without assessment)	+ \$0	
Z	the amount of rebates made	- <u>\$0⁹</u>	
		Less	<u>(\$11,100)</u>
	Underpayment		\$24,700

Because this taxpayer's self-reported tax liability for 2008 produced an underpayment, the section 6662 accuracy-related penalty applies. Because the accuracy-related penalty applies, the section 6676 penalty is inapplicable. See I.R.C. § 6676(c).

⁷ This memorandum assumes that this number reflects the correct tax imposed, including reductions for the allowable amount of the first-time homebuyer credit and recovery rebate credit.

Thus, the proper method for calculating this is:

correct total tax (line 44) (as determined by Service)	\$17,650
allowable portion of first-time homebuyer credit	(\$3,750)
allowable Recovery Rebate credit	<u>(\$ 300)</u>
Income Tax Imposed"	\$13,600

⁸ Here the taxpayer reported \$2,100 as his tax liability. The Service should reduce \$2,100 by the claimed credits for the EITC, additional child tax credit, first-time homebuyer credit and recovery rebate credit. The total of these credits is \$13,200. Reduction of the taxpayer's self-reported tax liability of \$2,100 by \$13,200 yields (\$11,100), a negative number. The Tax Court has applied the underpayment regulation to mean that variables X + Y – Z can yield a negative number. *Sadler v. Commissioner*, 113 T.C. 99, 9-10 (1999)(applying underpayment regulation to taxpayer's reported tax liability for 1989 and 1990 taxable years).

There is no need to further reduce the taxpayer's self-reported tax liability by an amount corresponding to the number of exemptions claimed (\$3,500 per exemption in tax year 2008) because this is already factored into the taxpayer's taxable income and tax, reported on lines 43 and 44 respectively.

⁹ In this case there is no rebate because no part of the refund paid to the taxpayer was made on the basis that the tax imposed by subtitle A is less than the tax shown on the return. Treas. Reg. § 301.6211-1(f). The tax imposed in this example is \$13,600, which is more than the tax shown on the return by the taxpayer.

Is there an understatement of tax?

Please refer to pages 4-6 of the November 20, 2009 memorandum for a discussion of how to apply the substantial understatement regulation (Treas. Reg. § 1.6662-4) to a taxpayer's reported liability. Applying the regulation's (Treas. Reg. § 1.6662-4) definition of "understatement" to this example yields the following:

X	amount of the tax required to be shown on the return		\$13,600
Y	amount of the tax imposed which is shown on the return	(\$11,100)	
Z	rebate	-\$ 0	
		Less	<u>(\$11,100)</u>
Understatement			\$24,700

The Service should next determine if the understatement is substantial, which will mean that the section 6662 penalty can be applied without further inquiry.

If there is an understatement of tax, is it substantial?

An understatement is substantial if exceeds the greater of \$5,000 or ten percent of the amount of tax required to be shown on the return for the taxable year. In this case ten percent of the tax required to be shown the return is \$1,360 (\$13,600 X 10%). Because petitioner's \$24,700 understatement exceeds \$5,000, it is substantial.

Even if this taxpayer's underpayment were not attributable to a substantial understatement of tax, there is still a possibility that the Service could determine the 6662 penalty applies on the alternative grounds that taxpayer was negligent or disregarded rules or regulations.

The facts do not indicate whether the taxpayer filed his return timely. If this were true, the Service can consider applying the late filing penalty under section 6651(a)(1). Because the failure to pay penalty in section 6651(a)(2) applies only to tax shown on a return not paid, this will not apply to this example. The facts do not show that fraud was involved in the taxpayer's reporting, which would be necessary to impose the 75% penalty under section 6663. If this penalty were applicable, then the Service would be precluded from also asserting the 6662 accuracy-related penalty. I.R.C. § 6662(b)(". . . This section shall not apply to any portion of an underpayment on which a penalty is imposed under section 6663."). No other penalties are implicated by the facts presented.

Example 2 – The taxpayer reported the following amounts on his Form 1040 for the 2008 taxable year:

Line 43 Taxable Income	\$ 1,300
Line 44 Tentative Tax	\$ 130
Line 57 Self-employment Tax	\$ 1,400
Line 61 Total Tax Liability	\$ 1,530
Line 62 Federal Tax Withholding	\$ 0
Line 64a Earned Income Credit (EITC)	\$ 2,900
Line 70 Recovery Rebate Credit	\$ 300
Line 73a Refund Amount	\$ 1,670

The Service examined the taxpayer's return to determine if the filing status, claimed exemptions for dependents and EITC were correct. During the examination, taxpayer submitted a Form 1040X for 2008 on which he claimed a first-time homebuyer credit (FTHBC) of \$8,000. The Service determined that taxpayer used an incorrect filing status, was not entitled to the dependency exemptions claimed, the EITC, or the FTHBC. Under the Service's calculations, the tax imposed should be \$1,200. The Service did not pay any portion of the refund requested by the taxpayer.

The Service should first apply the underpayment regulation to these facts.

Is there an underpayment?

W	amount of income tax imposed under subtitle A		\$1,200
X	amount shown as tax by the taxpayer on his return (line 61 less credits claimed)	(\$1,670)	
Y	amount not shown previously assessed (or collected without assessment)	+ \$0	
Z	the amount of rebates made	- <u>\$0</u>	
		Less	<u>(\$1,670)</u>
	Underpayment		\$2,870

Is there an understatement?

X	amount of the tax required to be shown on the return	\$1,200
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Y	amount of the tax imposed which is shown on the return		(\$1,670)
Z	rebate		-\$ 0
		Less	<u>(\$1,670)</u>
	Understatement		\$2,870

If there is an understatement, is it substantial?

An understatement is substantial if it exceeds the greater of: (i) ten percent of the tax required to be shown on the return; or (ii) \$5,000. In this case ten percent of the tax required to be shown on the taxpayer's return is \$120 (\$1,200 X .10). The taxpayer's understatement is not substantial because it does not exceed \$5,000. This conclusion does not preclude the Service from examining the taxpayer's reporting to determine if he is nonetheless liable for the 20% accuracy-related penalty due to the underpayment being attributable to negligence or disregard of rules or regulations.

The discussion under example 1 respecting other possible penalties applies to this example.

Example 3 – The taxpayer filed a Form 1040X for the 2008 taxable year in which he reported:

Line 61 Total Tax Liability	\$ 2,700
Line 69 First-time Homebuyer Credit (FTHBC)	\$ 8,000
Line 73a Refund Amount	\$ 5,300 ¹⁰

The Service paid the taxpayer \$5,300 as a refund. Later, through correspondence, the taxpayer provided documentation showing that the property for which he claimed the FTHBC was purchased in 2007. Accordingly, the Service determined that taxpayer was entitled to no part of the FTHBC for taxable year 2008. In examining the taxpayer's return, the Service made no changes to the taxpayer's self-reported liability, totaling \$2,700.

W	amount of income tax imposed under subtitle A		\$2,700
X	amount shown as tax by the taxpayer on his amended return (line 61 less credits claimed)		(\$5,300)

¹⁰ This example does not state the amount taxpayer claimed as a refund. We assume that no other credits are involved and that the Service first applied the FTHBC to the tax liability, refunding only the excess.

Y	amount not shown previously assessed (or collected without assessment)	+ \$0	
Z	the amount of rebates made	- <u>\$0</u>	
			Less <u>(\$5,300)</u>
	Underpayment		\$8,000

Is there an understatement?

X	amount of the tax required to be shown on the return		\$2,700
Y	amount of the tax imposed which is shown on the return	(\$5,300)	
Z	rebate	- <u>\$ 0</u>	
		Less	<u>(\$5,300)</u>
	Understatement		\$8,000

If there is an understatement, is it substantial?

An understatement is substantial if it exceeds the greater of: (i) ten percent of the tax required to be shown on the return; or (ii) \$5,000. In this case ten percent of the tax required to be shown on the taxpayer's return is \$270 (\$2,700 X .10). The taxpayer's understatement is substantial because it exceeds \$5,000. The section 6662 20% penalty therefore applies to the underpayment because of this substantial understatement of tax. This analysis does not foreclose the Service from determining, alternatively, that the taxpayer is subject to the 6662 penalty because his underpayment was attributable to negligence or disregard of rules or regulations.

Based on the limited facts presented, no other penalties or additions apply. See the discussion under example 1 in regard to other penalties that could apply if the factual situation supported such penalties.

The November 20, 2009 memorandum provided by our office includes seven examples. Examples 1-5 and example 7 illustrate taxpayers whose reporting produced underpayments. For each of these examples, imposition of the section 6662 accuracy-related penalty, rather than the penalty for erroneous refunds or credits, was correct.

Under the facts in Example 6 in the November 20, 2009 memorandum, the taxpayer is subject to the section 6676 penalty for making an excessive refund claim. In that

example the taxpayer's correct tax liability was \$2,400¹¹ and he claimed a refund of \$1,200. Because taxpayer's reporting did not result in an underpayment, the section 6662 accuracy-related penalty did not apply.

Calculation of the penalty in Example 6 is as follows. Taxpayer's liability was \$2,400 and there were allowable credits of \$3,000 for estimated tax payments made during the tax year. The Service ultimately determined that the taxpayer was not eligible for the \$600 additional child credit listed on line 68 of the tax return. Thus, the taxpayer was entitled to \$600 as a refund or credit, rather the full \$1,200 claimed on line 74a. In this situation, the "excessive amount," under I.R.C. § 6676(b) is \$600 and is subject to a 20% penalty.

Finally, you requested our assistance in placing the results of our analysis into a chart or table, which could help the Service best apply the appropriate penalty for the circumstances at hand. You provided an illustrative example that includes columns with the headings "if" and "then." The illustration suggests that selection of the correct penalty between the accuracy-related penalty of section 6662 and the section 6676 penalty for erroneous refund or credit claims hinges on whether "tax imposed" is a positive or negative number.

One suggested format of a spreadsheet or chart for use by the Service's income tax return examiners is to make it flow from the concept of underpayment.

Step 1

Does the taxpayer's reporting result in an underpayment, as defined the regulation implementing section 6664?

If yes, proceed to step 2.

If no, skip steps, 2 and 3. Proceed to step 4.

Step 2 – Determine if the underpayment resulted from fraud by the taxpayer

If yes, analyze the case under I.R.C. § 6663 to determine if the 75% penalty applies. IRM 20.1.5.12.

If no, analyze the facts presented by the taxpayer's filing under the section 6662 accuracy-related penalty. IRM 20.1.5.7. Proceed to step 3.

Step 3 – Determine the cause of the underpayment

¹¹ In applying the underpayment regulation's definition of "amount of income tax imposed," (variable W), the Service did not reduce the tax liability by the \$600 claimed as an additional child tax credit because the Service's audit revealed the taxpayer was ineligible for it.

The accuracy-related penalty will apply to a taxpayer filing an income tax return if any of the following is satisfied:

- The taxpayer made an underpayment because of negligence or disregard of rules or regulations.
- The underpayment was attributable to the taxpayer's substantial understatement of tax (two questions must be answered: (i) was there an understatement of tax per Treas. Reg. § 1.6662-4(b)(2); and (ii) if so, was it substantial?)
- The taxpayer made a substantial valuation misstatement of property or basis on his return

If none of these apply, the taxpayer is not subject to the section 6662 penalty

Step 4 – Does the penalty for an erroneous claim for refund or credit apply? IRM 20.1.5.14.

Has the taxpayer made a claim for refund or credit?

If no, the section 6676 penalty does not apply.

If yes, was the claim for an excessive amount, which means the disallowable portion of the claim?

If yes, the section 6676 could apply, unless the taxpayer can show that he had a reasonable basis as a defense to the penalty.

Was there a reasonable basis for the taxpayer making a claim for such excessive amount?

If yes, the section 6676 penalty does not apply

If no, the penalty applies and is equal to 20 percent of the excessive amount of the refund or credit claim.

Additional considerations

Did the taxpayer make a reportable transaction understatement?

Analyze the case under I.R.C. § 6662A. IRM 20.1.5.13

Because of the significant number of variables in each of the components of the regulatory definitions *underpayment* and *understatement*, it will be difficult to create a chart or table containing only 2 or 3 columns that will adequately reflect when each of the penalties apply. The correct figure corresponding to each of the components will depend on the taxpayer's particular situation. For example, the number representing

“amounts not so shown previously assessed (or collected without assessment),” within the underpayment regulation can include:

-amounts not so shown previously assessed - An amount assessed before the return was filed, such as a section 6851 termination assessment or a jeopardy assessment under section 6861

-amounts collected without assessment – the amount by which the total of the credits allowable with withholding of tax on wages, withheld tax at the source on nonresident aliens or foreign corporations, estimated tax and other payments made to satisfy the tax before the return is filed exceed the “tax shown on the return.” Such amount collected without assessment, however, exists only if the excess has not been refunded to the taxpayer. Treas. Reg. § 1.6664-2(d).

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 (202) 622-4910 if you have any further questions.

cc: Division Counsel
(Small Business/Self-Employed)