



OFFICE OF
CHIEF COUNSEL

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

CC:DOM:IT&A:4:RBTaylor
WTA-N-120803-98

DATE: 11 21 1998

MEMORANDUM FOR JOAN DOLIAN (DIRECTOR, OFFICE OF PENALTY
ADMINISTRATION) OP:EX:ST:P
Attn: Bob Curran

FROM: Assistant Chief Counsel (Income Tax & Accounting)
CC:DOM:IT&A:4

SUBJECT: Section 6662(c) Penalties and EIC

This is in response to your memorandum requesting assistance dated November 13, 1998. The issue in your memorandum presented a dispute in the applicability of § 6662(c) on pre-refund earned income credit (EIC) adjustments. You stated that your reason for requesting our assistance was due to a conflict between Examination and District Counsel in the Western Region. In order to resolve the issue, you wanted us to provide answers to a series of questions attached to your memorandum.

Issues

Whether the definition of underpayment under § 6664, for the purposes of the accuracy related penalty under § 6662, includes adjustments for EIC when calculating the underpayment.

Whether the definition of underpayment, as it relates to the accuracy related penalty under § 6662(c), is different depending on whether the Service has issued a refund prior to an EIC adjustment.

Conclusion

The definition and calculation of an underpayment under § 6662(c), as defined in § 6664, includes adjustments for EIC. In addition, the calculation will remain the same regardless of whether or not the Service has issued a refund. However, the result of the calculation will be different depending on whether the Service has issued a refund.

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Analysis

Section 32 provides for an earned income tax credit (EIC) that can be used by eligible individuals against their income tax. The EIC under § 32 is a refundable credit. See § 6401(b)(1).

Section 6662(c) imposes a penalty in the case of an underpayment attributable to negligence or disregard of rules or regulations.

Section 6664(a) defines underpayment as the amount by which the tax imposed exceeds the excess of the sum of (1) the amount shown as the tax by the taxpayer on his return, plus (2) amounts not so shown previously assessed (or collected without assessment), over (3) the amount of rebates made. The definition of underpayment is also expressed under § 1.6664-2(a)(2) of the regulations as:

$$\text{Underpayment} = W - (X+Y-Z),$$

where W = the amount of income tax imposed; X = the amount shown as the tax by the taxpayer on his return; Y = amounts not so shown previously assessed (or collected without assessment); and Z = the amount of rebates made.

Section 1.6664-2(b) provides that the "amount of income tax imposed" means the amount of tax imposed on the taxpayer by the Service. This amount is determined without regard to (1) credits or payments under §§ 31 (relating to tax withheld on wages) and 33 (relating to tax withheld at source on nonresident aliens and foreign corporations); (2) payments of tax or estimated tax by the taxpayer; (3) a credit resulting from amounts assessed under § 6851 as the result of a termination assessment, or § 6861 as the result of a jeopardy assessment; and (4) tax not required to be assessed on the return (such as the tax imposed by § 531 on the accumulated taxable income of a corporation).

Section 1.6664-2(c)(1) defines the "amount shown as the tax by the taxpayer on his return" as the tax liability shown by the taxpayer on his return. This amount is determined without regard to the items listed in § 1.6664-2(b)(1), (2), and (3) (as listed in above paragraph). However, unlike the computation of the "amount of income tax imposed" in 1.6664-2(b), this amount is reduced by any overstated prepayment credits claimed on the return. Overstated prepayment credits include overstated withholding under §§ 31 and 33, estimated tax payments, and any other payment made by the taxpayer for the taxable year.

Section 1.6664-2(d) provides that "amounts not so shown previously assessed" means only amounts assessed before the return is filed that were not shown on the return. These amounts include termination assessments and jeopardy assessments.

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Section 1.6664-2(d) also provides that the amount "collected without assessment" means the amount by which the total of the §§ 31 and 33 credits, estimated tax payments, and other payments, exceed the tax, provided the excess has not been refunded to the taxpayer. Generally, this includes a refund claimed on the return that has not been issued pending an examination.

Section 1.6664-2(e) defines "rebate" as abatements, credits, refunds or other repayments made on the ground that the tax imposed was less than the excess of the sum of the amount shown on the return, plus, amounts not so shown previously assessed (or collected without assessment), over rebates previously made.

Sections 1.6664-2(b), and (c)(1) do not specifically address how to factor the § 32 credit into the formula prescribed for calculating an underpayment. However, some guidance may be derived from the language of § 1.6664-2(b) and (c). Both of these subsections state the calculations are to be made "without regard" to the §§ 31 and 33 credits, estimated tax payments, and other payments. This would suggest that the "amount of tax imposed" and the "amount shown as the tax by the taxpayer on his return" should be computed "with regard" to other refundable credits, such as § 32, when determining the underpayment amount.

In addition, § 1.6664-2(d) relating to amounts "collected without assessment," does not address how to factor § 32 credits that are in excess of tax shown on the return, provided such amount has not been refunded. Any excess amount, generally the refund amount as shown on the taxpayer's return, should not be reduced by the amount of the disallowed EIC. The EIC has already been subtracted from the "amount shown as the tax by the taxpayer on his return." Disallowing the EIC as part of the refund amount would result in a double reduction, causing the calculation of underpayment to be incorrect.

Based on this analysis, if a refund has not been issued pending an audit examination and the audit results in a disallowance of an EIC, the underpayment is computed as follows: (1) the "amount shown as tax by the taxpayer on his return" is reduced by the EIC; and (2) the amount of refund shown on the tax return would be the amount "collected without assessment," computed without a reduction for the disallowed EIC.

If, however, the taxpayer received a refund and the audit results in a disallowance of an EIC, the underpayment is computed as follows: (1) the "amount shown as tax by the taxpayer on his return" is reduced by the EIC; and (2) the amount "collected without assessment" is 0 because the credits and payments that exceed the tax shown on the return were refunded.

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Your specific examples are answered below. In each example, unless otherwise noted we assume that the § 6662(c) has been imposed and that the criteria for imposing § 6662(c) has been met for the EIC adjustment.

Example 1

Taxable Income Shown on Return	\$15,000
Tax Imposed (determined by Service)	\$15,000
Tax Shown on Return	\$2,000
Tax Imposed (determined by Service)	\$2,000
Withholding Shown on Return	\$2,500
Correct Withholding (determined by Service)	\$2,500
EIC Shown on Return	\$800
Correct EIC (determined by Service)	\$0
Refund Shown on Return	\$1,300
Correct Refund (determined by Service)	\$500

If the above example occurs in a **pre-refund** examination, the underpayment amount is:

Underpayment = tax imposed less tax shown on the return reduced by the § 32 credit shown on the return plus the refund requested on the return but not issued by the Service.

$$\text{Underpayment} = \$2000 - [(\$2000 - \$800) + \$1300]$$

$$\text{Underpayment} = -\$500, \text{ or no underpayment}$$

If the above example occurs in a **post-refund** examination, the underpayment amount is:

Underpayment = tax imposed less tax shown on the return reduced by the § 32 credit shown on the return plus 0 (because the Service issued the refund amount requested).

$$\text{Underpayment} = \$2000 - [(\$2000 - \$800) + 0]$$

$$\text{Underpayment} = \$800$$

If the above example only includes a **partial-refund** in the amount of \$500, the underpayment amount is:

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Underpayment = tax imposed less tax shown on the return reduced by the § 32 credit shown on the return plus the refund requested on the return but not issued by the Service.

$$\text{Underpayment} = \$2000 - [(\$2000 - \$800) + \$800]$$

$$\text{Underpayment} = \$0, \text{ or no underpayment}$$

Example 2

Taxable Income Shown on Return	\$15,000
Tax Imposed (determined by Service)	\$15,000
Tax Shown on Return	\$2,000
Tax Imposed (determined by Service)	\$2,000
Withholding Shown on Return	\$1,800
Correct Withholding (determined by Service)	\$1,800
EIC Shown on Return	\$800
Correct EIC (determined by Service)	\$0
Refund Shown on Return	\$600
Correct Refund (determined by Service)	\$0

If the above example occurs in a **pre-refund** examination, the underpayment amount is:

Underpayment = tax imposed less tax shown on the return reduced by the § 32 credit shown on the return plus the refund requested on the return but not issued by the Service.

$$\text{Underpayment} = \$2000 - [(\$2000 - \$800) + \$600]$$

$$\text{Underpayment} = \$200$$

If the above example occurs in a **post-refund** examination, the underpayment amount is:

Underpayment = tax imposed less tax shown on the return reduced by the § 32 credit shown on the return plus 0 (because the Service issued the refund amount requested).

$$\text{Underpayment} = \$2000 - [(\$2000 - \$800) + 0]$$

$$\text{Underpayment} = \$800$$

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Example 3 (Example 3B in your memo):

Taxable Income Shown on Return	\$15,000
Tax Imposed (determined by Service)	\$21,000
Tax Shown on Return	\$2,000
Tax Imposed (determined by Service)	\$2,900
Withholding Shown on Return	\$2,500
Correct Withholding (determined by Service)	\$2,700
EIC Shown on Return	\$800
Correct EIC (determined by Service)	\$0
Refund Shown on Return	\$1,300
Correct Refund (determined by Service)	\$0

In this example, the adjustment that increases taxable income is subject to the § 6662(c) penalty.

If the above example occurs in a **pre-refund** examination, the underpayment amount is:

Underpayment = tax imposed less tax shown on the return reduced by the § 32 credit shown on the return plus the refund requested on the return but not issued by the Service and the correct withholding in excess of the withholding shown on the return.

$$\text{Underpayment} = \$2900 - [(\$2000 - \$800) + (\$1300 + \$200)]$$

$$\text{Underpayment} = \$200$$

If the above example occurs in a **post-refund** examination, the underpayment amount is:

Underpayment = tax imposed less tax shown on the return reduced by the § 32 credit shown on the return plus 0 (because the Service issued the refund amount requested).

$$\text{Underpayment} = \$2900 - [(\$2000 - \$800) + 0]$$

$$\text{Underpayment} = \$1700$$

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Example 4 (Example 3A in your memo):

Taxable Income Shown on Return	\$15,000
Tax Imposed (determined by Service)	\$21,000
Tax Shown on Return	\$2,000
Tax Imposed (determined by Service)	\$2,900
Withholding Shown on Return	\$2,500
Correct Withholding (determined by Service)	\$2,700
EIC Shown on Return	\$800
Correct EIC (determined by Service)	\$0
Refund Shown on Return	\$1,300
Correct Refund (determined by Service)	\$0

In this example, the adjustment that increases Taxable Income is **not** subject to the §6662(c) penalty. Thus, the \$900 tax adjustment not subject to § 6662(c) penalty must be accounted for as provided in the ordering rules under § 1.6664-3. See § 1.6664-3(d) Example 3.

If the above example occurs in a **pre-refund** examination, the underpayment amount is:

Underpayment = tax imposed less tax shown on the return reduced by the § 32 credit.

Underpayment = \$2900 - (\$2000 - \$800)

Underpayment = \$1700 (note: \$900 from tax adjustment and \$800 from EIC)

Total Credits = \$1500 (\$1300 refund shown on the return that has not been issued and \$200 additional withholdings not shown on the return)

Credits available to be applied against underpayment subject to the penalty = Total Credits reduced by underpayment amount not subject to the penalty.

Credits available to be applied against underpayment subject to the penalty = \$1500 - \$900

Credits available to be applied against underpayment subject to the penalty = \$600

Underpayment subject to the penalty = \$800 (EIC) - \$600 (credit available)

Underpayment subject to the penalty = \$200

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If the above example occurs in a **post-refund** examination, the underpayment amount is:

Underpayment = tax imposed less tax shown on the return reduced by the § 32 credit.

Underpayment = \$2900 - (\$2000 - \$800)

Underpayment = \$1700

Total Credits = \$200 (additional withholdings)

Credits available against the underpayment subject to the penalty = \$0 [\$200 - \$900 (portion of the underpayment not subject to the penalty)]

Underpayment subject to the penalty = \$800 (EIC) - \$0 (credit available)

Underpayment subject to the penalty = \$800

If you have any questions or concerns regarding this reply, please contact Brad Taylor at (202) 622-4940.

JODY J. BREWSTER

By: _____
ROCHELLE L. HODES
Senior Technician Reviewer
Branch 4