

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

CC:PA:01  
POSTS-128277-09

UILC: 6662.00-00

date: November 20, 2009

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subject: Accuracy-Related Penalty on Underpayments

This responds to your request for additional assistance.

ISSUE

Whether the accuracy-related penalty of I.R.C. § 6662 applies in the situations described below?

CONCLUSIONS

The following discussion includes a conclusion regarding each of the tax returns for which transcripts were submitted.

DISCUSSION

I.R.C. § 6662 provides that a taxpayer is liable for an accuracy-related penalty ("penalty") equal to 20% of the amount of an underpayment attributable to, among other things, a substantial understatement of income tax. Welter v. Commissioner, T.C. Memo 2003-299. An understatement of income tax is deemed substantial if the amount exceeds the *greater* of: (i) 10 percent of the tax required to be shown on the return for the year, or (ii) \$5,000. I.R.C. § 6662(d)(1)(A); Fields v. Commissioner, T.C. Memo 2008-207 (substantial understatement where tax reported was \$89,507, tax required to be shown on return totaled \$259,476 and resulting understatement of \$169,969 exceeded 10 % of amount required to be shown on return). The Commissioner bears the burden of production. Connolly v. Commissioner, T.C. Memo 2007-98 (*citing*

**PMTA 2010-01**

§ 7491(c)). Once the Commissioner meets his burden of production, the taxpayer continues to have the burden of proof regarding whether the Commissioner's determination of the penalty is correct. Fields, supra.

The Code further provides that the amount of an understatement is reduced to the extent it is attributable to a position (i) for which there is substantial authority, or (ii) which the taxpayer adequately disclosed on his tax return and for which there is a reasonable basis. *Id.* at § 6662(d)(2)(B). The penalty does not apply to that portion of an underpayment if it is shown that there was reasonable cause for such portion and the taxpayer acted in good faith. *Id.* at § 6664(c)(1).

### ***Underpayment of Tax***

The Service has asked whether the penalty applies for a taxable year when the taxpayer claims a first-time homebuyer credit (FTHBC) or earned income credit (EIC) to which he is not entitled but nonetheless receives a tax refund because the sum of his other allowable credits exceeds the tax due for the year. In this memorandum, we apply I.R.C. §§ 6662 and 6664 to the sample tax returns submitted.

As a threshold matter, there must be an "underpayment" for the particular tax year in order for the penalty to apply. Treas. Reg. § 1.6664-2(a) expresses the definition of "underpayment" for purposes of the penalty by the following formula: 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;  $Y$  = the amounts not so shown previously assessed (or collected without assessment), and  $Z$  = the amount of rebates made.

Treasury Reg. § 1.6664-2(b) and (c)(1) do not specifically address how to factor the FTHBC into the formula for calculating an underpayment. This office has previously taken the position that because these subsections state that the calculations are to be made "without regard" to the section 31 and 33 credits, estimated payments and other payments, 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 the FTHBC or EIC, when determining if there is an underpayment amount. SCA 200113028 (March 30, 2001).

Additionally, Treas. Reg. § 1.6664-2(d), relating to amounts "collected without assessment," does not indicate how to factor in any FTHBC or EIC in excess of tax shown on the return, which has not been refunded to the taxpayer. Any excess amount of a refundable credit, which is generally the entire refund amount shown on the taxpayer's return, should not be reduced by the amount of the disallowed refundable credit. Such credit has already been subtracted from the "amount shown as the tax by the taxpayer on his return." To disallow the credit as part of the refund amount would result in a double reduction, causing the calculation of the underpayment to be incorrect. TAM 2841039058 (March 21, 1998).

Use the following principles when applying the regulation to taxpayers' accounts. If the Service has not issued a refund and audit examination or other review of the return results in the disallowance of the FTHBC or EIC, the "underpayment" is computed as follows:

(i) the "amount of income tax imposed" (variable W) is the tax determined taking into account credits (not including those for withholding tax, estimated tax and other cash payments) allowed by the Service;

(ii) the "amount shown as the tax by the taxpayer on his return" (variable X) is reduced by the FTHBC, EIC or other claimed tax credit and is also reduced by credits claimed for withholding, estimated tax or other payments that exceed what was actually paid in to the Service for the year;

(iii) the "amounts not shown previously assessed" (variable Y) means amounts assessed before the taxpayer filed his return, but which are not shown on the tax return (e.g. a termination assessment or jeopardy assessment);

(iv) the amount "collected without assessment" (variable Y) is the amount by which the sum of credits for withholding, estimated tax, and other cash payments made exceed the tax shown on the return, provided such excess has not been refunded to the taxpayer; and

(v) "rebate" (variable Z) is the amount of credit, refund or other repayment, made on the basis that the tax imposed was less than the excess of the sum of: [(i) the amount shown as the tax by the taxpayer on his return + (ii) amounts not shown as the tax by the taxpayer on his return previously assessed (or collected without assessment)], over rebates previously made. Treas. Reg. §1.6664-2(b), (c) and (d). TAM 2841039058 (March 21, 1998).

If, however, the taxpayer received a refund and the audit results in the disallowance of the FTHBC or EIC, the underpayment is computed as follows: (i) the "amount shown as the tax by the taxpayer on his return" is still reduced by the claimed FTHBC or EIC; but (ii) the amount "collected without assessment" is 0 because the credits and payments that exceed the tax shown on the return have been refunded.

### ***Substantial Understatement of Tax***

Treas. Reg. § 1.6662-4, which pertains to the phrase "substantial understatement of income tax," states in part:

**§ 1.6662-4. Substantial understatement of income tax.**—(a) *In general.*—If any portion of an underpayment, as defined in section 6664(a) and § 1.6664-2, of any income tax imposed under subtitle A of the Code that is required to be shown on a return is attributable to a substantial understatement of such

income tax, there is added to the tax an amount equal to 20 percent of such portion . . .

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Except in the case of any item attributable to a tax shelter, an understatement is reduced by the portion of such understatement attributable to the tax treatment of an item: (i) for which there is substantial authority; or (ii) which was adequately disclosed on the return and there is a reasonable basis for the tax treatment of such item by the taxpayer. Under present law, no reduction to the understatement is allowed if it relates to a tax shelter item. I.R.C. § 6662(d)(2)(C). The penalty does not apply to the portion of the underpayment for which the taxpayer can show that there was reasonable cause, and that he acted in good faith respecting such portion. Treas. Reg. § 1.6662-4(a) (*citing* Treas. Reg. 1.6664-4)

Treas. Reg. § 1.6662-4(b)(2) of this regulation interprets the statutory definition of “understatement” as follows:

“Understatement” can be expressed as

Understatement =  $X - (Y - Z)$ , where X = the amount of the tax required to be shown on the return, Y = the amount of the tax imposed which is shown on the return, and Z = any rebate. An “understatement” is determined without taking into account reportable transaction items covered by the penalty of I.R.C. § 6662A. I.R.C. § 6662(d)(2).

The “amount of the tax required to be shown on the return” (X) for the taxable year has the same meaning as “amount of income tax imposed” in § 1.6664-2(b). Treas. Reg. § 1.6662-4(b)(3)

The “amount of the tax imposed which is shown on the return” (Y) for the taxable year has the same meaning as the “amount shown as the tax by the taxpayer on his return,” as defined in § 1.6664-2(c), except that:

(i) there is no reduction for the amount by which the taxpayer claims credits for withholding tax, estimated payments or other cash payments in an amount greater than the payments actually made;

(ii) the tax liability shown by the taxpayer on his return is recomputed as if the following items had been properly reported:

- Items, (other than tax shelter items as defined in § 1.6662-4(g)(3)), for which there is substantial authority for the treatment claimed (as provided in § 1.6662-4(d)).

- Items, (other than tax shelter items as defined in § 1.6662-4(g)(3)), with respect to which there is adequate disclosure, and for which there is a reasonable basis for the taxpayer's treatment. (as provided in § 1.6662-4(e) and (f)).

Treas. Reg. § 1.6662-4(b)(4)<sup>1</sup>.

“Rebate” means the same as it is defined in § 1.6664-2(e), except

- “Amounts not so shown previously assessed (or collected without assessment)” includes only amounts not so shown previously assessed (or collected without assessment) as a deficiency, and
- The amount of the rebate is determined as if any items to which the rebate is attributable that are described in Treas. Reg. § 1.6662-4(b)(4) of this section (described above) had received proper tax treatment.

Treas. Reg. § 1.6662-4(b)(5)(i) and (ii).

No information accompanied the request to our office indicating the reason the Service disallowed any of the taxpayers' claimed FTHBCs, EICs or additional child tax credits or whether any of the taxpayers could show reasonable cause in claiming the credit. Moreover, there is no indication in this or any of the other examples that a tax shelter item was involved, or that substantial authority exists supporting each taxpayer's treatment of the item in question. I.R.C. § 6662(d)(2)(B)(i) and (C). For purposes of applying the Code and regulations to these examples, we have assumed that none of these variables are present.

Under Treas. Reg. § 1.6662-4(e) and (f), disclosure is adequate regarding the taxpayer's position or item if made on a properly completed form attached to the tax return or amended return. For items or positions not contrary to a regulation, the taxpayer must use Form 8275, and for a position contrary to a regulation, the taxpayer must use Form 8275-R. The regulation also authorizes the Commissioner to annually publish by revenue procedure the circumstances under which disclosure of information on a return (or amended return) in accordance with the applicable forms and instructions is adequate. If the annual revenue procedure does not address an item, disclosure is adequate only if made on a properly completed Form-8275 or 8275-R. Treas. Reg. § 1.6662-4(f)(1) and (2).

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<sup>1</sup> The current version of this regulation is outdated. Consequently, the above discussion takes into account 2003 and 2004 Code amendments that changed the criteria for reducing the amount of an understatement and eliminated the provision which allowed for a reduction of the understatement attributable to a tax shelter in certain circumstances.

Currently, Rev. Proc. 2008-14 provides guidance respecting the proper disclosure that can reduce the understatement of income tax under I.R.C. § 6662(d). Rev. Proc. 2008-14 does not mention the FTHBC, EIC or other tax credits which can be claimed on a Form 1040. Consequently, disclosure respecting these items is adequate only if the taxpayer attached to his return a properly completed Form-8275 or 8275-R. The examples do not indicate or suggest that any taxpayer completed and attached a Form 8275 or 8275-R to his filed return. We therefore assume that none of the understatements can be reduced on the basis that there was adequate disclosure and the taxpayer had a reasonable basis for the treatment. I.R.C. § 6662(d)(2)(B).

**Example 1** - For the 2008 taxable year, the taxpayer reported the following on his Form 1040:

Line 43 Taxable Income	\$ 00
Line 44 Tentative tax	\$ 00
Line 57 Self-employment tax	\$ 00
Line 62 tax withheld	\$ 00
Line 67 Amount paid with extension request	\$ 300
Line 69 FTHBC	\$ 8,000
Line 73a Refund amount	\$ 8,300

This is a **pre-refund** examination by the Service. The Service's records indicate that the taxpayer is entitled to a refundable credit in the amount of \$200, attributable to the economic stimulus legislation. The taxpayer is apparently unaware that he is entitled to this credit for 2008, and no part of the \$200 credit is shown on his return. The Service has determined that the taxpayer is not entitled to the FTHBC.

Under the Service's calculations, the taxpayer is entitled to a refund in the amount of \$500, comprised of the credit due to the economic stimulus legislation plus the \$300 payment made with the request for an extension of time to file. As of this date, the Service has issued no refund to the taxpayer.

Application of the underpayment formula to the facts presented is as follows:

W	amount of income tax imposed under subtitle A	(\$200) <sup>2</sup>
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<sup>2</sup> This is calculated as follows:

Service's Calculation of Tax liability	\$ 0
Economic stimulus Credit	(\$200)
	(\$200)

The taxpayer's \$300 estimated payment is not part of this calculation. Treas. Reg. § 1.6664-2(b)

X	amount shown as tax by the taxpayer on his return (line 44)	(-\$8,000) <sup>3</sup>
Y	Tax previously assessed (or collected without assessment)	\$300
Z	amount of rebates made	<u>- none</u>
		Less <u>(\$7,700)</u>
	Underpayment	\$7,500

Under this calculation, both the “amount of income tax imposed” and the product of the remaining variables in the formula are negative numbers. Subtracting a negative is the equivalent of adding the corresponding positive. *Wikipedia, free Encyclopedia, Addition and Subtraction*. The taxpayer made an underpayment for 2008 in the amount of \$7,500 and therefore, one must make further inquiry into whether the penalty applies.

Application of I.R.C. § 6662 and the substantial understatement regulation to these facts shows that the taxpayer made a substantial understatement of tax for the 2008 tax year, calculated as follows:

X	amount of the tax required to be shown on the return	(\$200)
Y	amount of the tax imposed which is shown on the return	(\$8,000)
Z	rebate	<u>-\$ 00</u>
		Less <u>(\$8,000)</u>

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<sup>3</sup> The “amount shown as the tax by the taxpayer on his return” under Treas. Reg. § 1.6664-2(c), is calculated by first identifying the sum shown on line 44 of the taxpayer’s Form 1040, here \$0, and taking into account the credits shown on the taxpayer’s return (not including, however, credits for withholding, estimated tax and the remaining items described in Treas. Reg. § 1.6664-2(b)). Service Center Advisory 200113028 (February 26, 2001), at pg. 5. The resulting amount is then reduced by the excess of: (the amounts shown as credits for withheld tax, payments of estimated tax or other payments made respecting the taxable year before the filing of the return) over (the amounts actually withheld, paid as estimated tax or paid before the return is filed).

For this return the starting point is \$0 from which the claimed \$8,000 FBHBC is subtracted. No further adjustment is needed because the taxpayer did not claim a credit for withholding, estimated tax or other cash payment in excess of what was actually paid in.

Understatement \$7,800

The understatement in this example in the amount of \$7,800 is substantial because it exceeds the greater of \$5,000 or (\$20), the latter equaling ten percent of the amount of tax required to be shown on the return for the taxable year. Welter, supra (understatements of tax totaling \$25,310 and \$19,408 for 1994 and 1996 respectively, attributable to taxpayers' mischaracterization of gains were substantial). Consequently, the taxpayer is liable for an addition to tax totaling 20% of the underpayment attributed to this substantial understatement. Thus the penalty is  $(\$7,500 \times .2) = \$1,500$

**Example 2** – For the 2008 taxable year, the taxpayer reported the following on his Form 1040

Line 7 wages	\$ 45,000
Line 21 other income	\$ (45,000)
Line 43 taxable income	\$ 00
Line 44 tentative tax	\$ 00
Line 57 employment tax	\$ 00
Line 62 income tax withheld	\$ 00
Line 63 estimated payments	\$ 00
Line 69 FTHBC	\$ 8,000
Line 73a refund amount	\$ 8,000

This involves a **pre-refund** examination. The taxpayer attached to his 2008 1040 a Form 2555 on which he listed \$45,000 as being subject to the foreign earned income exclusion (per line 21 of his return). The Service has not yet examined this aspect of the taxpayer's return and the copy of the Income Tax Examination Changes (Form 4549) for this year proposes no deficiency respecting the 2008 return. The below discussion assumes that the taxpayer properly excluded the wages from U.S. income tax. The Service has determined that the taxpayer is not entitled to the FTHBC and has accordingly not paid any part of the refund requested.

Applying Treas. Reg. § 1.6664-2(a) to these facts yields the following:

W amount of income tax imposed under subtitle A	\$0
X amount shown as the tax by the taxpayer on his return	(\$8,000)
Y Amounts not shown previously assessed (or collected without assessment)	+\$ 00
Z amount of rebates made	<u>-\$ 00</u>



	Less <u>(\$8,000)</u>
Underpayment	\$8,000

Subtraction of the negative amount, derived from the product of  $(X + Y - Z)$ , from zero is equivalent to adding a positive amount. Thus, the taxpayer has made an underpayment of \$8,000 under I.R.C. § 6664(a). Further analysis is thus needed to determine if the section 6662 penalty applies.

Application of I.R.C. § 6662 and the substantial understatement regulation to these facts shows that the taxpayer made a substantial understatement of tax for the 2008 tax year, calculated as follows:

X amount of the tax required to be shown on the return		\$0
Y amount of the tax imposed which is shown on the return	(\$8,000) <sup>4</sup>	
Z rebate	<u>-\$ 00</u>	
	Less	<u>(\$8,000)</u>
Understatement		\$8,000

The understatement in this example in the amount of \$8,000 is substantial because it exceeds the greater of \$5,000 or \$0, the latter equaling ten percent of the amount of tax required to be shown on the return for the taxable year. Consequently, the taxpayer is liable for an addition to tax totaling 20% of the underpayment attributed to this substantial understatement. The penalty is  $\$8,000 \times .20 = \$1,600$

**Example 3** - For the 2008 taxable year, the taxpayer reported the following on her Form 1040:

Line 8a taxable interest	\$ 50
Line 37 AGI	\$ 50
Line 43 taxable income	\$ 00
Line 44 tentative tax	\$ 00
Line 62 tax withheld	\$ 00
Line 63 estimated tax payments	\$ 00
Line 69 FTHBC	\$7,500

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<sup>4</sup> This is the same as the "amount shown as tax by the taxpayer on his return" under Treas. Reg. § 1.6664-2(c).

Line 73 refund amount \$7,500

In this **post-refund** examination, the Service refunded the sum of \$7,500 to the taxpayer, but later determined that she is not entitled to any part of the FTHBC. The Service is currently proposing to issue a notice of deficiency to the taxpayer in connection with the invalid FTHBC.

Applying Treas. Reg. § 1.6664-2(a) to these facts yields the following:

W amount of income tax imposed		\$0
X amount shown as the tax by the Taxpayer on his return (line 44, reduced by the claimed FTHBC)	(\$7,500)	
Y Tax previously assessed (or collected without assessment)	\$ 00	
Z rebate made	<u>\$ 00</u>	
	less	<u>(\$7,500)</u>
Underpayment		\$7,500

An underpayment in the amount of \$7,500 exists in this taxpayer's 2008 module. Consequently, we must determine if the penalty applies.

Application of I.R.C. § 6662 and the substantial understatement regulation to these facts shows that the taxpayer made a substantial understatement of tax for the 2008 tax year, calculated as follows:

X amount of the tax required to be shown on the return		\$0
Y amount of the tax imposed which is shown on the return	(\$7,500) <sup>5</sup>	
Z rebate	<u>-\$ 00</u>	
	Less	<u>(\$7,500)</u>
Understatement		\$7,500

<sup>5</sup> This is the same as the "amount shown as tax by the taxpayer on his return" under Treas. Reg. § 1.6664-2(c).

The understatement in this example in the amount of \$7,500 is substantial because it exceeds the greater of \$5,000 or \$0, the latter equaling ten percent of the amount of tax required to be shown on the return for the taxable year. Consequently, the taxpayer is liable for an addition to tax totaling 20% of the underpayment attributed to this substantial understatement. The penalty is  $\$7,500 \times .20 = \$1,500$ .

**Example 4** – For the 2008 tax year, the taxpayer reported the following on his Form 1040:

Line 22 total income	\$50,000
Line 43 taxable income	\$25,500
Line 44 tentative tax (per 2008 tax table, pg 68 2008 Form 1040)	\$ 3,428
Line 52 child tax credit	\$ 1,000
Line 55 total statutory credits	\$ 1,000
Line 57 self-employment tax	\$ 100
Line 61 total tax	\$ 2,528
Line 62 tax withheld	\$ 3,000
Line 63 estimated tax payments	\$ 00
Line 69 FTHBC	\$ 7,500
Line 71 total payments	\$ 10,500
Line 73a refund amount	\$ 7,972

This is a **post-refund** examination. The Service initially allowed both the child tax credit and FTHBC claimed by the taxpayer. Consequently, the Service paid the taxpayer a refund of \$7,972, the amount shown on the return. The Service later determined that the taxpayer is not entitled to the FTHBC. The Service is currently proposing to also increase the taxpayer's self-employment tax liability (line 57) from 100 to \$250. Accordingly, the Service has prepared an Income Tax Examination Changes Form 4549 in which these adjustments result in a balance due of \$7,650 plus interest.

Applying Treas. Reg. § 1.6664-2(a) to these facts yields the following:

W amount of income tax imposed	\$2,678 <sup>6</sup>
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<sup>6</sup> This is calculated as follows

	Tentative Tax (Ln 44)	\$ 3,428
less	Child Tax Credit (Ln 52)	<u>-\$ 1,000</u>
		\$2,428
	Self-employment (Ln 57)	\$ 100
	Additional Self-Emp. Tax	<u>\$ 150</u>
	Tax	\$2,678

X amount shown as the tax by the taxpayer on his return	(\$4,972) <sup>7</sup>	
Y Amounts not shown previously assessed (or collected without assessment)	+\$ 00	
Z amount of rebates made	<u>-\$ 00</u>	
		less <u>(\$4,972)</u>
Underpayment		\$7,650

The taxpayer made an underpayment totaling \$7,650 as defined under I.R.C. § 6664 and the regulation. Next, we determine if the taxpayer also made a substantial understatement of tax.

Application of section 6662 and the substantial understatement regulation to these facts shows that the taxpayer made a substantial understatement of tax for the 2008 tax year, calculated as follows:

X amount of the tax required to be shown on the return		\$2,678
Y amount of the tax imposed which is shown on the return	(\$4,972) <sup>8</sup>	
Z rebate	<u>-\$ 00</u>	
		Less <u>(\$4,972)</u>
Understatement		\$7,650

<sup>7</sup> This is calculated as follows:

Tentative tax (Ln 44)	\$3,428
Self-employment (Ln 57)	<u>\$ 100</u>
Tax shown on return	\$3,528
Less Child Tax Credit	<u>-\$1,000</u>
	\$2,528
Less Claimed FTHBC	<u>-\$7,500</u>
	(-\$4,972)

<sup>8</sup> This is the same as the "amount shown as tax by the taxpayer on his return" under Treas. Reg. § 1.6664-2(c).

The understatement in this example in the amount of \$7,650 is substantial because it exceeds the greater of \$5,000 or \$267.80, the latter equalling ten percent of the amount of the tax required to be shown on the return for the taxable year. Consequently, the taxpayer is liable for an addition to tax equal to 20% of the underpayment attributed to this substantial understatement. The penalty is  $\$7,650 \times .20 = \$1,530$ .

**Example 5** - For the 2007 taxable year, the taxpayers reported the following on their joint Form 1040:

Line 12 business income	\$ 18,000
Line 22 total income	\$ 18,000
Line 27 self-employment tax deduction	\$ 1,000
Line 37 AGI	\$ 17,000
Line 43 Taxable Income	\$ 00
Line 44 Tentative Tax	\$ 00
Line 58 Self employment tax	\$ 2,400
Line 63 total tax liability	\$ 2,400
Line 64 Income tax withheld	\$ 00
Line 65 Estimated tax payments	\$ 00
Line 66a Earned Income Credit	\$ 2,800
Line 68 Additional Child Tax Credit	\$ 600
Line 72 Total Payments	\$ 3,400
Line 74a Refund Amount	\$ 1,000

In this **post-refund** example the Service initially accepted the return as filed and accordingly paid the requested refund in the amount of \$1,000. The Service thereafter audited the taxpayers' return and determined that they are not entitled to the EIC or additional child tax credit. The Service has prepared an income tax examination change form (Form 4549) which includes adjustments to the gross receipts and sales on the taxpayers' schedule C which results in \$1,500 income tax, rather than \$0 (Ln. 44) reported by the taxpayers. The Form 4549 also reflects the Service's increase to the self-employment tax liability by \$900, from \$2,400 to \$3,300.

Applying Treas. Reg. § 1.6664-2(a) to these facts yields the following:

W amount of income tax imposed	\$4,800 <sup>9</sup>
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<sup>9</sup> This is calculated as follows

Corrected Income tax Liability	\$ 1,500
Corrected Self-employment tax	<u>\$3,300</u>
	\$4,800

X amount shown as the tax by the taxpayer on his return	(\$1,000) <sup>10</sup>
Y Amounts not shown previously assessed (or collected without assessment)	+\$ 00
Z amount of rebates made	<u>-\$ 00</u>
	less <u>(\$1,000)</u>
Underpayment	\$5,800

The taxpayers made an underpayment, as defined by Code section 6664, totaling \$5,800. As a result, further analysis is needed to determine if the penalty applies. Application of I.R.C. § 6662 and the implementing regulation, Treas. Reg. § 1.666-2 – 1.6662-4, to these facts shows that the taxpayer made a substantial understatement of tax for the 2008 tax year, calculated as follows:

X amount of tax required to be Shown on the return	\$4,800
Y amount of the tax imposed which is shown on the return	(\$1,000)
Z rebate	<u>-\$ 00</u>
	Less <u>(\$1,000)</u>
Understatement	\$5,800

The understatement in this example in the amount of \$5,800 is substantial because it exceeds the greater of \$5,000 or \$480.00, the latter equaling 10% of the amount of tax required to be shown on the return for the taxable year. Consequently, the taxpayer is

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<sup>10</sup> This is calculated as follows:

Tentative tax (Ln 44)	\$ 00
Self employment (Ln 58)	<u>+\$ 2,400</u>
Total tax liability (Ln 63)	\$ 2,400
Less claimed Earned Income Credit	<u>-\$ 2,800</u>
	(\$ 400)
additional	
child tax credit claimed	<u>(\$ 600)</u>
tax shown on return by taxpayer	(\$1,000)

liable for an addition to tax totaling 20% of the underpayment attributed to this substantial understatement. The penalty is  $\$5,800 \times .20 = \$1,160$

**Example 6** - Assume that the taxpayers in example 5 did not claim the EIC, the Service made no adjustments to the business income and self-employment tax reported by the taxpayers, and the taxpayers made estimated payments totaling \$3,000. Also assume that the Service's examination of the return is done **pre-refund**.

Line 12 Business Income	\$ 18,000
Line 22 total income	\$ 18,000
Line 27 Self-employment tax deduction	\$ 1,000
Line 37 AGI	\$ 17,000
Line 43 Taxable Income	\$ 00
Line 44 Tentative Tax	\$ 00
Line 58 Self-employment tax	\$ 2,400
Line 63 total tax liability	\$ 2,400
Line 64 Income tax withheld	\$ 00
Line 65 Estimated tax payments	\$ 3,000
Line 66a Earned Income Credit	\$ 00
Line 68 Additional Child Tax credit	\$ 600
Line 72 Total Payments	\$ 3,600
Line 74a Refund Amount	\$ 1,200

In this **pre-refund** example the Service reviewed the return and determined that the taxpayers are not entitled to the additional child tax credit. The Service has not yet paid any part of the refund, which means that amounts "collected without assessment" in the calculation of "underpayment" includes the estimated tax payments held by the Service.

Applying Treas. Reg. § 1.6664-2(a) to these facts yields the following:

W amount of income tax imposed	\$2,400 <sup>11</sup>
X amount shown as the tax by the taxpayer on his return	\$1,800 <sup>12</sup>

<sup>11</sup> This is the total liability reported on line 63 of the Form 1040. There is no \$600 for the claimed additional child tax credit because the Service has determined that the taxpayer is ineligible for it.

<sup>12</sup> This is calculated as follows:

Tentative tax (Ln 44)	\$ 00
Self employment (Ln 58)	<u>+\$ 2,400</u>
Total tax liability (Ln 63)	\$ 2,400
Less claimed additional	

Y	Amounts not shown previously assessed (or collected without assessment)	+\$3,000
Z	amount of rebates made	<u>-\$ 00</u>
		less <u>\$4,800</u>
	Underpayment	(\$2,400)

The taxpayers have made no underpayment, as defined by I.R.C. § 6664, and the implementing regulation. Subtraction of a positive number, here \$4,800, from \$2,400 yields a number lower than zero as the “underpayment.” I.R.C. § 6662(b) states, in part, “[t]his section shall *apply to the portion of any underpayment* which is attributable to 1 or more of the following: (1) Negligence or disregard of the rules or regulations. (2) Any substantial understatement of income tax . . .” (emphasis added). Because the taxpayers have not made an underpayment for the taxable year in this example, the penalty authorized by I.R.C. § 6662 does not apply.

**Example 7** - For the 2008 tax year, the taxpayer reported the following on his Form 1040:

Line 43 taxable income	\$ 00
Line 44 tentative tax	\$ 00
Line 57 Self-employment tax	\$ 350
Line 61 total tax liability	\$ 350
Line 62 Income tax withheld	\$ 00
Line 63 estimated tax payments	\$ 00
Line 69 FTHBC	\$7,250
Line 73a Refund amount	\$6,900

In this **post-refund** example, the Service paid the taxpayer the refund amount shown on line 73a of his return. Later the Service determined that the taxpayer is ineligible for the FTHBC and has accordingly proposed issuing a deficiency notice to recover the FTHBC, plus a penalty, interest and the penalty authorized by I.R.C. § 6662.

Applying Treas. Reg. § 1.6664-2(a) to these facts yields the following:

W	amount of income tax imposed	\$350
X	amount shown as the tax by	

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child tax credit	<u>-\$ 600</u>
Tax Shown on return by taxpayer	\$1,800



	the taxpayer on his return	(\$6,900) <sup>13</sup>	
Y	Amounts not shown previously assessed (or collected without assessment)	+\$ 00	
Z	amount of rebates made	<u>-\$ 00</u>	
		Less	<u>(\$6,900)</u>
	Underpayment		\$7,250

Because the taxpayer has made an underpayment for the year, as defined in I.R.C. § 6664, further analysis is needed to determine if the underpayment warrants application of the penalty. The substantial understatement regulation applied to this situation discloses that the taxpayer made a substantial understatement of tax for the 2008 tax year. This is calculated as follows:

X	amount of the tax required to be shown on the return		\$350
Y	amount of the tax imposed which is shown on the return	(\$6,900) <sup>14</sup>	
Z	rebate	<u>-\$ 00</u>	
		Less	<u>(\$6,900)</u>

<sup>13</sup> This is calculated as follows:

Tentative tax (Ln 44)	\$ 00
Self employment tax (Ln 57)	<u>+\$ 350</u>
Total tax liability (Ln 61)	\$ 350
Less claimed FTHBC	<u>-\$7,250</u>
Tax Shown on return by taxpayer	(\$6,900)

<sup>14</sup> This is the same as the "amount shown as tax by the taxpayer on his return" for purposes of defining an underpayment pursuant to Treas. Reg. § 1.6664-2(c), and the facts do not require any of the adjustments required when the understatement is reduced because there is substantial authority for the treatment or the position was adequately disclosed on the tax return and there is a reasonable basis for the treatment. See pp. 4-5 above, which discusses "amount of the tax imposed which is shown on the return" (variable Y) under Treas. Reg. 1.6662-4(b)(4).

Tentative tax (Ln 44)	\$ 00
Self employment tax (Ln 57)	<u>\$ 350</u>
Total tax liability (Ln 61)	\$ 350
Less claimed FTHBC	<u>-\$7,250</u>
Tax Shown on return by taxpayer	(\$6,900)

Understatement

\$7,250

This understatement is substantial because it exceeds the greater of \$5,000 or \$35.00 (.1 X \$350), which is 10% of the amount of tax required to be shown on the return for the taxable year. Consequently, the taxpayer is liable for an addition to tax totaling 20 percent of the underpayment attributed to this substantial understatement. The penalty is  $\$7,250 \times .20 = \$1,450$ .

### CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

A significant point raised by the above discussion is whether the concept of negative tax applies when determining if a taxpayer made an understatement or an underpayment as those terms are defined in I.R.C. §§ 6662 and 6664 and the implementing regulations. As these examples illustrate, the most common situation is when the taxpayer claims a refundable credit in an amount exceeding the tax shown on the return for which he is ineligible.

Service Center Advisory 200112001 (March 23, 2001) (SCA) involved, in part, whether there could be an “understatement” when determining whether a taxpayer qualified for innocent spouse relief (§ 6015(b)), when the adjustment of tax on the return takes into account omitted income caused by disallowance of the EIC. “Understatement” for purposes of the section 6015 provision has the same meaning as understatement in I.R.C § 6662(d)(2)(A). I.R.C. § 6015(b)(3).

In addressing the situation of a claimed EIC exceeding the tax shown on the return, this office concluded in this SCA that the “amount of the tax imposed which is shown on the return” under Treas. Reg. 1.6662-4(b)(3) could be a negative number. In support of this, the SCA cited the definition of a deficiency under I.R.C. § 6211 and legislative history, noting that subsection (b)(4) requires that certain excess credits claimed exceeding the tax shown on the return by the taxpayer (determined without regard to the credits) be taken into account as “negative amounts of tax.”

In analyzing whether the Service correctly imposed the penalty, courts have typically concluded that “substantial” understatements were present in the cases before them based on the amounts of unreported income, with no express analysis of the terms contained in Treas. Reg. § 1.6662-4. Fields v. Commissioner, T.C. Memo 2008-207 (taxpayer’s 2003 return reported tax of \$89,507 while tax required to be reported was \$259,476, and thus understatement totaling \$169,969 exceeded 10% of the amount required to be reported); Connoly v. Commissioner, T.C. Memo 2007-98 (unreported income, payable in 18 annual installments from discrimination lawsuit settlement was substantial); Larson v. Commissioner, T.C. Memo 2002-295 (penalty applied where taxpayer reported only \$1,891.95 as non-employee compensation but Form 1099 reporting the income mistakenly typed the “2” in the sum \$21,891.95 over top of the \$).

No court has addressed whether the concept of “negative tax” for purposes of calculating a deficiency also applies in the context of calculating an “underpayment” within the meaning of I.R.C. §§ 6662, 6664(a) or Treas. Reg. §§ 1.6662-4(b)(2)(understatement defined) and 1.6664-2(a)(underpayment defined). There is the possibility that the Tax Court will follow Solomon v. Commissioner, T.C. Summary opinion 2008-07 and not take into account a refundable credit (other than withholding tax, estimated tax or other cash payments) when calculating the “amount of income tax imposed” and the “amount shown as tax by the taxpayer on his return.” Our office takes the position that the EIC or FTHBC claimed by the taxpayer reduces the sum which he reports as his tax for the year. The court could support its holding by pointing out that Congress thought of the concept of “negative tax” and intentionally incorporated it into the deficiency definition (§ 6211(a) and (b)(4)) but not the underpayment or understatement definitions. If the court rules against the Service, however, it will have to ignore the idea that refundable credits can be seen as payments or negative tax because these are paid to the taxpayer to the extent they exceed the taxpayer’s liability for the year.

Finally, we note that the above application of the section 6662 penalty results in the same treatment to those reporting positive taxable income (line 43, 2008, Form 1040) and tax (line 44, 2008 Form 1040) and those taxpayers reporting \$0 taxable income and \$0 tax for the year. The penalty should apply equally to both groups who claim credits to which they are not entitled.

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