

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

CC:PA:01:GSemasek  
POSTS-119273-12

UILC: 6664.01-00, 6662.00-00

date: May 30, 2012

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subject: Accuracy-Related Penalty on Underpayments – Frozen Refundable Tax Credits

This program manager technical assistance memorandum (PMTA) relates to the advice our office provided to SBSE Campus Compliance Services in regard to the above topic. In two separate memoranda, one dated November 20, 2009 and another August 27, 2010, our office provided advice in relation to the application of the accuracy-related penalty to taxpayers who filed returns claiming refundable tax credits, such as the first-time homebuyer credit (FTHBC). The memorandum of November 20, 2009 included seven examples of various situations in which the Service determined that the taxpayers were not entitled to the refundable credits claimed on the tax returns they filed. The memorandum of August 27, 2010 included 3 examples and also discussed the penalty imposed by I.R.C. § 6676 for making claims for excessive refunds or credits. A copy of each memorandum is attached.

We have reconsidered our advice in regard to application of the accuracy-related penalty in the situation when the Service does not pay a refund or approve a credit to the taxpayer when he claims a refundable tax credit to which he is not entitled. In many cases involving this fact pattern, absent additional circumstances, there will be no “underpayment”, as that term is defined in section 6664. Without an underpayment there can be no liability for the accuracy-related penalty. Below, we revise examples 1, 2 and 6 from the November 20, 2009 memorandum and example 2 from the August 27, 2010 memorandum to reflect this interpretation of “underpayment.”

PMTA 2012-16

## ISSUE

Is there an “underpayment” if the taxpayer claims a FTHBC, earned income credit (EIC) or other refundable tax credit to which he is not entitled, the amount of the credit exceeds the tax shown on the return but the Service does not pay the taxpayer a refund or allow a carry-forward credit?

## CONCLUSIONS

No, in most of the examples below.

## FACTS

The Service previously asked whether the accuracy-related penalty applies for a taxable year when the taxpayer claims a FTHBC or EIC to which he is not entitled. In some of the cases the Service paid refunds or allowed carry-forward credits to taxpayers but after subsequent investigation determined the taxpayers were ineligible for the FTHBC, EIC or other credit. In other cases the Service made this determination and accordingly did not pay the requested refunds or allow any carry-forward credits.

The addition of the FTHBC to the Code as part of the Housing Assistance Tax Act of 2008, P.L. 110-289, § 3011(a), 122 Stat. 2654 (and later amendments to the FTHBC) has, during the past few years, increased the number of tax returns potentially exposed to the accuracy-related penalty. Because an allowable FTHBC could be \$7,500 or \$8,000 for a taxable year, a taxpayer ineligible for the credit who nonetheless claimed it on his return exposed himself to imposition of the accuracy-related penalty based on making a substantial understatement of tax on his return. For most taxpayers an understatement of tax exceeding \$5,000 is a “substantial understatement” under I.R.C. § 6662(d)(1).

## DISCUSSION

### ***Is there underpayment of tax?***

In order for the accuracy-related penalty of I.R.C § 6662 to apply, the taxpayer’s reporting must result in an “underpayment” for the particular tax year.<sup>1</sup> Underpayment is defined in I.R.C. § 6664 and the implementing regulation expresses the definition of this term 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. Treas. Reg. § 1.6664-2(a)

To identify the specific amount that is assigned to each of the variables in the underpayment formula of section 1.6664-2, the Service should continue to use the

<sup>1</sup> Similarly, the civil fraud penalty provided by section 6663 applies when the taxpayer’s reporting results in an “underpayment” for the taxable year.

discussion in the August 27, 2010 memorandum, footnotes 4 through 7 (pages 4-5), with the following exception. We recommend that the Service treat a FTHBC, EIC or other refundable credit which has not been refunded or credited to the taxpayer, i.e. a frozen refund, as an “amount not so shown previously assessed (or collected without assessment)” (variable Y). Treas. Reg. § 1.6664-2(d). The below discussion provides further instructions as to identifying the number assigned to Y.

If the Service has not refunded or allowed a credit to the taxpayer for the erroneously or fraudulently claimed FTHBC or EIC, absent additional circumstances, the amount of such credit is added to Y because it is a sum collected without assessment. For most taxpayers the net result will be that X and Y cancel each other out and consequently no “underpayment” exists.

The following are revisions to the examples from the November 20, 2009 and August 27, 2010 memoranda.

*November 20, 2009 memorandum*

**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 First-time Homebuyer Credit (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 he did not claim this on his return. The Service, however, determined that the taxpayer is not entitled to any of the FTHBC.

Under the Service’s calculations, the taxpayer is entitled to a refund totaling \$500, comprised of the \$200 economic stimulus credit 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>
X	amount shown as tax by the taxpayer on his return (line 44)				(-\$8,000) <sup>3</sup>
Y	Amounts not so shown previously assessed (or collected without assessment)			+\$ 8,300 <sup>4</sup>	
Z	amount of rebates made	less		\$ <u>00</u>	
					Less <u>\$ 300</u>
	Underpayment				(\$ 500)

Under this calculation there is no underpayment because the result of application of the regulatory formula to these facts produces a number less than \$0. 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 taxpayer has not made an underpayment for taxable year 2008 in this example, the accuracy-related penalty of section 6662 does not apply. As a result,

<sup>2</sup> This is calculated as follows:

Service’s Calculation of	
Tax liability	\$ 0
Economic stimulus	
Credit	<u>(\$200)</u>
	(\$200)

Under the regulation, the taxpayer’s \$300 payment made with his extension request is not considered when making this calculation. Treas. Reg. § 1.6664-2(b)(defining “income tax imposed”).

<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 Service reduces this variable by the claimed FTHBC. The resulting amount is then reduced by any overstated withholding or overstated estimated tax payment amount(s), if the taxpayer made such overstatement. Treas. Reg. § 1.6664-2(c)(i) & (ii).

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 payment in excess of what was actually paid to the Service.

<sup>4</sup> This is calculated as follows:

Amount paid with extension request:	\$ 300
FTHBC	<u>\$8,000</u>
	\$8,300

there is no need to consider whether the taxpayer made a substantial understatement of tax, was negligent or disregarded a rule or regulation.

The taxpayer in Example 1 may, however, be liable for the 20% penalty under I.R.C. § 6676(a) for making a claim for an excessive refund, unless he can show that there was a reasonable basis for such claim. An “underpayment” is not a prerequisite to imposition of the section 6676 penalty.

**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. The taxpayer listed this as a negative number on line 21 of his Form 1040. 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 taxpayer’s 2008 tax 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.

Application of the underpayment formula 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)	+\$8,000 <sup>5</sup>	
Z amount of rebates made	less	<u>-\$ 00</u>

<sup>5</sup> This is the sum “collected without assessment” and it represents the claimed FTHBC which has not been refunded or allowed as a carry-forward credit to the taxpayer.

	Less <u>\$ 0</u>
Underpayment	\$ 0

In this example there is no underpayment and therefore the accuracy-related penalty under I.R.C. § 6662 does not apply. Because no underpayment exists, it is not necessary to consider whether the taxpayer made a substantial understatement of tax, was negligent or disregarded rules or regulations.

The Service may wish to consider applying the penalty of section 6676 to this taxpayer, who made an excessive refund claim.

**Example 6** – The taxpayers, a couple, reported the following on their return for taxable year 2007.<sup>6</sup> The Service did a **pre-refund** examination of the taxpayers’ return, meaning no refund was paid or carry-forward credit approved for any of the payments made or refundable credits claimed.

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

The Service reviewed the taxpayers’ return and determined that they are not entitled to the additional child tax credit. The Service has not yet paid any refund to the taxpayers or allowed a credit. As a result, in the calculation of the “underpayment” in Treas. Reg. § 1.6664-2 the “amount not so shown previously assessed (or collected without assessment)” (variable Y) includes the estimated tax payments exceeding the tax shown on the return (variable X).

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

<sup>6</sup> We revised the narrative description of this example from the November 20, 2009 memorandum because there the paragraph began with the phrase “Assume that the taxpayers in example 5 did not claim the EIC . . .” Because we have not repeated or revised example 5 in this memorandum, the wording above creates a stand-alone example that has no facts incorporated from another example. The income and credit figures, though, are the same as those from the November 20, 2009 memorandum.

W	amount of income tax imposed		\$2,400 <sup>7</sup>
X	amount shown as the tax by the taxpayer on his return	\$1,800 <sup>8</sup>	
Y	Amounts not shown previously assessed (or collected without assessment)	+\$1,200 <sup>9</sup>	
Z	amount of rebates made	less <u>-\$ 00</u>	
			less <u>\$3,000</u>
	Underpayment		(\$ 600)

The taxpayers have made no underpayment because application of the underpayment formula of Treas. Reg. § 1.6664-2 to the facts yields a number less than zero. These taxpayers may, however, be liable for the penalty under section 6676.

The other examples in the November 20, 2009 memorandum, which involve post-refund reviews of tax returns, are unaffected by this memorandum.

*August 27, 2010 memorandum<sup>10</sup>*

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

Line 43	Taxable income	\$1,304
Line 44	Tentative tax	\$ 131

<sup>7</sup> This represents the total liability reported on line 63 of the Form 1040, determined without regard to credits for withholding, estimated tax or other payments. Treas. Reg. § 1.6664-2(b). There is no reduction for the \$600 claimed additional child tax credit because the Service determined the taxpayer to be ineligible for it.

<sup>8</sup> This is calculated as follows:

Tentative tax (Ln 44)	\$ 00
Self employment (Ln 57)	<u>+\$ 2,400</u>
Total tax liability (Ln 63)	\$ 2,400
Less claimed additional child tax credit	<u>-\$ 600</u>
Tax Shown on return by taxpayer	\$1,800

Under Treas. Reg. § 1.6664-2(b)(2), the taxpayer's estimated tax payments are not part of this calculation.

<sup>9</sup> The total of estimated tax payments, here \$3,000, exceeds the tax shown on the return of \$1,800 by the amount of \$1,200. This excess has not been refunded or allowed as a carry-forward credit to the taxpayers. Treas. Reg. § 1.6664-2(d).

<sup>10</sup> The facts in example 1 in the August 27, 2010 memorandum do not state whether the Service froze the taxpayer's requested refund, which included a number of refundable credits. Because of this ambiguity, we recommend that the Service discontinue using example 1.

Line 57 Self-employment tax	\$1,455
Line 61 Total tax liability	\$1,586
Line 62 Tax withheld	\$ 00
Line 64a Earned income credit (EIC)	\$2,917
Line 70 Recovery rebate credit	\$ 300
Line 73a Refund amount	\$1,631

The Service examined the taxpayer's return to determine if the filing status, claimed exemptions for dependents and EIC were correct. During the examination the taxpayer submitted a Form 1040X for 2008 on which he claimed a FTHBC of \$8,000. The Service determined that the taxpayer used an incorrect filing status, was not entitled to dependency exemptions, the EIC or the FTHBC. Under the Service's calculations, the tax imposed should be \$1,286. 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. This calculation is as follows:

W amount of income tax imposed		\$1,286 <sup>11</sup>
X amount shown as the tax by the taxpayer on his return	(\$1,631) <sup>12</sup>	
Y Amounts not shown previously assessed (or collected without assessment)	+\$1,631 <sup>13</sup>	
Z amount of rebates made	<u>-\$ 00</u>	
	less	<u>\$ 0</u>
Underpayment		\$1,286

<sup>11</sup> This is calculated as:

Total tax liability	\$1,586
Allowable recovery rebate credit	<u>-\$ 300</u>
	\$1,286

Example 2 from the August 27, 2010 memorandum lists "\$1,216" as the amount assigned to variable W. This appears to have been a mistake.

<sup>12</sup> This is comprised of:

Total tax liability	\$ 1,586
Less credits claimed by the taxpayer	<u>-\$ 3,217</u>
	(\$ 1,631)

<sup>13</sup> The represents the total of the credits claimed exceeding the tax shown on the return which was not refunded.

The taxpayer's reporting for taxable year 2008 resulted in an underpayment. Consequently, he can be liable for the accuracy-related penalty if this underpayment was attributable to negligence or disregard of rules or regulations. Use the following steps to determine if, alternatively, the taxpayer's reported underpayment is attributable to a substantial understatement of tax. Apply the formula contained in Treas. Reg. § 1.6662-4(b)(2), which defines expresses "understatement" as-

$$\text{Understatement} = X - (Y - Z)$$

Where X = the amount of tax required to be shown on the return; Y = the amount of tax imposed which shown on the return; and Z = any rebate.

X amount of the tax required to be shown on the return		\$1,286
Y amount of the tax imposed which is shown on the return	(\$1,631)	
Z rebate	<u>\$ 0</u>	
Understatement		Less <u>(\$1,631)</u> \$2,917

Under I.R.C. § 6662(d), 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. Ten percent of the tax required to be shown on the taxpayer's 2008 return is \$128.60 (10% X \$1,286) and this is less than \$5,000. Because the taxpayer's \$2,917 understatement did not exceed \$5,000, it is not a substantial understatement.

Example 3, which is the last illustrative example in the August 27, 2010 memorandum, is not affected by this advice because it did not involve a frozen refund.

### ***Non-frozen refunds***

In Yitzchok Rand & Shulamis Klugman v. Commissioner, Docket No. 2633-11, the Tax Court will decide whether there is an underpayment, and thus liability for the accuracy-related penalty, for the petitioners' 2008 taxable year, when they claimed the EIC, the additional child tax credit and recovery rebate credit. The Service paid the requested refund in Rand, but later discovered that the petitioners were not entitled to the refundable tax credits. Thus Rand is very similar to the post-refund examples discussed in our prior memoranda on this topic. The Rand case was submitted to the Tax Court as a fully stipulated case in March 2012.

Please call Gerald Semasek at (202) 622-4910 if you have any further questions.

Attachments:

- 1) PMTA 2010-001
- 2) PMTA 2011-003