

LR #8 **ERRONEOUS REFUND PENALTY: Amend Section 6676 to Permit “Reasonable Cause” Relief**

PROBLEM

A taxpayer who claims a tax credit or refund that the IRS disallows may be liable for a penalty under Internal Revenue Code (IRC) § 6676 unless the taxpayer had a “reasonable basis” for the claim.¹ Section 6676 does not appear to require the IRS to take into account all the facts and circumstances, including the taxpayer’s knowledge and experience with tax law and his or her efforts to comply with the law, in determining whether there was such reasonable basis. Taxpayers may satisfy the reasonable basis standard if they have “substantial authority” for their return position, but substantial authority does not include IRS forms or accompanying instructions, IRS publications, or IRS answers to Frequently Asked Questions—materials that many individual taxpayers rely on for guidance.

While the section 6676 penalty does not apply to erroneous claims for the Earned Income Tax Credit (EITC), it may apply to disallowed claims for other social benefits, such as the additional child tax credit and the new Premium Tax Credit under the Affordable Care Act (ACA).² The rules for claiming these income-based refundable credits, available to low income taxpayers who face unique obstacles in understanding and substantiating eligibility, are complex and varied, which raises the likelihood of mistakes.³ Other tax penalties, including the civil fraud penalty, contain an exception for “reasonable cause.”⁴ Determining whether there was “reasonable cause” for a claim requires consideration of all of the taxpayer’s facts and circumstances.⁵

According to the Taxpayer Bill of Rights (TBOR), taxpayers have the *right to a fair and just tax system*—“the right to expect the tax system to consider facts and circumstances that might affect their underlying liabilities ...”⁶ Subjecting taxpayers to a penalty for claiming a disallowed refund without taking into account their facts and circumstances impairs their right to a fair and just tax system. For these reasons the National Taxpayer Advocate reiterates her 2011 recommendation that Congress amend IRC § 6676 to allow a reasonable cause exception.⁷

- 1 See IRC § 6676 (a), imposing the penalty on “a claim for refund or credit with respect to income tax” made “for an excessive amount.” Under IRC § 6676(b), the amount of the penalty is 20 percent of the excessive (*i.e.*, disallowed) amount.
- 2 See IRC § 6676(a) (excluding the earned income tax credit under IRC § 32); IRC § 24 (providing for the child tax credit and the additional child tax credit, which is the part of the credit that is refundable); IRC § 36B (providing for the premium tax credit). There has been at least one legislative proposal to remove the exclusion of EITC claims. See H.R. 5070, 113th Cong., 2d Sess. § 6 (July 10, 2014).
- 3 See National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2 at 93. (Research Study: *Running Social Programs Through the Tax System*); National Taxpayer Advocate 2009 Annual Report to Congress 110-13 (Most Serious Problem: *Beyond EITC: The Needs of Low Income Taxpayers Are Not Being Adequately Met*) (“Although a diverse population, low income taxpayers do share common characteristics. Low income taxpayers are found more frequently among the elderly, the disabled, Native Americans, and taxpayers who may have limited English proficiency (LEP) relative to the general Wage and Investment (W&I) taxpayer population. Many require extra assistance to understand tax law changes, as demonstrated by the widespread confusion about the 2008 Economic Stimulus Payment (ESP) and the resulting flood of calls to the IRS toll-free line. Low income taxpayers tend to be more transitory than the general population, with 27.5 percent of those below the poverty level moving in 2007 while only 15 percent of the general population moved during the same time.” (fn refs. omitted)).
- 4 See IRC § 6664(c).
- 5 See, *e.g.*, Treas. Reg. § 1.6664-4(b)(1).
- 6 Taxpayer Bill of Rights, *available at* <http://taxpayeradvocate.irs.gov/About-TAS/Taxpayer-Rights#rights>.
- 7 National Taxpayer Advocate 2011 Annual Report to Congress 544 (Legislative Recommendation: *Amend the Erroneous Refund Penalty to Permit Relief in Case of Reasonable Cause for Claim to Refundable Credits*).

EXAMPLE

During tax year 2014, X and Y, high school graduates with no significant tax law knowledge or experience, have two dependent children and household income of around \$45,000. X and Y paid a commercial return preparer to prepare their joint federal tax return for 2013, which they decide to use as a starting point for preparing their own 2014 return. X and Y learn that because both their children are under 19 in 2014, they will be responsible for the Shared Responsibility Payment (SRP) if their children do not have required health insurance.⁸ After X and Y obtain insurance for the family, they predict the amount of their household income for the year and find that, based on their projections, they qualify for advanced premium tax credits (APTC). These credits are paid directly to their insurer throughout 2014.

As in 2013, X and Y's 2014 tax liability was paid through wage withholding, so their 2014 return properly shows no tax due. Like the 2013 return, the 2014 return claims a refund for EITC and an additional \$2,000 refund for the additional child tax credit (\$1,000 for each child). Because X and Y actually earned slightly less than the amount they projected, they are entitled to an additional premium tax credit which they calculated to be \$1,500. Thus, their total refund claim on their 2014 return is \$3,500, not counting EITC. The IRS examines the return and determines X and Y are entitled to the claimed EITC, but not the child tax credit for their child who turned 17 years old in 2014.⁹ The IRS also determines that although X and Y are entitled to a refund for the additional premium tax credit, they miscalculated the amount, which should be \$1,000. Thus, X and Y are entitled to a total refund of \$2,000, not counting EITC. The IRS denies \$1,500 of X and Y's original \$3,500 refund claim and assesses a \$300 penalty despite the couple's good faith efforts to comply with the tax law and their lack of education, knowledge, or experience with taxes. There is no authority that would support X and Y's claim for \$1,500 of the refund shown on their tax return (and X and Y concede their error). X and Y would not be able to show they had a reasonable basis for their claim and would not be eligible for relief from the penalty under IRC § 6676. If there were a reasonable cause exception to the penalty, X and Y might be able to show that taking into account all their facts and circumstances, they are eligible for penalty relief.

RECOMMENDATION

To allow for consideration of taxpayers' facts and circumstances before imposing a penalty for erroneously claiming a credit or refund, the National Taxpayer Advocate recommends that Congress amend IRC § 6676 to permit relief from the penalty for individual taxpayers who acted with reasonable cause and in good faith.

8 Per Treas. Reg. § 1.5000A-1(c)(2), "if the nonexempt individual is a dependent (as defined in section 152) of another individual for the other individual's taxable year including that month, the other individual is liable for the shared responsibility payment attributable to the dependent's lack of coverage. An individual is a dependent of a taxpayer for a taxable year if the individual satisfies the definition of dependent under section 152, regardless of whether the taxpayer claims the individual as a dependent on a Federal income tax return for the taxable year." Under IRC § 152(c)(3), X and Y's children will be dependents until they are 19 or, if students, age 24.

9 Under IRC § 24(c)(1), the term "qualifying child" for purposes of the child tax credit means a qualifying child of the taxpayer (as defined in section 152(c)) who has not attained age 17.

PRESENT LAW

Section 6662 imposes an accuracy-related penalty applicable to underpayments of income tax.¹⁰ In simplified terms, “underpayment” means the excess of a taxpayer’s actual liability over his or her reported liability—“*i.e.*, tax ‘imposed’ minus tax ‘shown’ equals ‘underpayment’.”¹¹

The accuracy-related penalty does not apply where the taxpayer acted with reasonable cause and in good faith.¹² According to the applicable Treasury regulation:

[t]he determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances ... Generally, the most important factor is the extent of the taxpayer’s effort to assess the taxpayer’s proper tax liability. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer.¹³

Until 2013, the IRS successfully asserted the accuracy-related penalty with respect to disallowed credits claimed on original returns, whether the credit only reduced tax or also resulted in a claim for refund.¹⁴ Taxpayers could avoid imposition of the penalty by demonstrating they had reasonable cause for claiming the disallowed credit.¹⁵ As discussed below, these procedures have changed in light of the Tax Court’s decision in *Rand v. Commissioner*.¹⁶

In the meantime, in 2007 Congress filled a perceived gap in the penalty framework by enacting section 6676, which imposes a penalty of 20 percent of an excessive claim for refund or credit.¹⁷ To the extent a disallowed credit other than EITC generates a refund, it may be subject to a penalty under section 6676.¹⁸

10 IRC § 6662 penalizes underpayments of tax otherwise owed attributable to negligence or disregard of rules or regulations, substantial understatements of tax (*i.e.*, failing to show ten percent of the correct tax or \$5,000, whichever is more), or certain other factors. The amount of the penalty is 20 percent of the amount of the underpayment.

11 *Rand v. Comm’r*, 141 T.C. 376, 399 (2013) (Gustafson, J., dissenting).

12 IRC § 6664(c).

13 Treas. Reg. § 1.6664-4(b)(1).

14 See *Rand v. Comm’r*, 141 T.C. 376 (2013) and cases cited therein at p. 389, n. 10. See also IRS Program Manager Technical Advice (PMTA) 2012-016, 2012 TNT 163-18 (Aug. 22, 2012), explaining that the IRS would continue to seek imposition of the accuracy-related penalty for disallowed claims for refundable credits, except where the IRS did not actually pay a refund or approve the credit.

15 Because deficiency procedures apply to imposition of the penalty under section 6662, taxpayers could contest liability for the penalty in the Tax Court before being required to pay it. IRC § 6665.

16 141 T.C. 376 (2013).

17 According to the Department of Treasury, “[d]isallowing a refund or credit claim does not result in an underpayment. Absent a frivolous position evident on the face of the return, there is no accuracy-related penalty applicable to disallowance of a refund or credit claim.” Dept. of Treas., *Gen. Explanations of the Admin’s FY 2008 Rev. Proposals* (Feb. 2007) at 82, available at <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2008.pdf>. Consequently, a taxpayer with a return position (such as a claim for a tax credit) believed to increase exposure to the accuracy-related penalty under section 6662 might bifurcate his or her tax reporting. An original return omitting the credit and showing zero tax due, followed by an amended return claiming the credit results in neither return containing an underpayment, even if the claimed credit on the amended return generated a refund that was paid and the credit then disallowed. See National Taxpayer Advocate 2011 Annual Report to Congress 544, 546 (Legislative Recommendation: *Amend the Erroneous Refund Penalty to Permit Relief in Case of Reasonable Cause for Claim to Refundable Credits*); Sharyn M. Fisk and Heather Kim Lee, *Section 6676 Erroneous Claim For Refund Or Credit Penalty: The Penalty Has No Reasonable Basis* 9 (prepared for the Taxation Procedure & Litigation Committees of the Taxation Sections of the State Bar of California and the Los Angeles County Bar Association), available at <http://www.lacba.org/Files/Main%20Folder/Sections/Taxation/Files/2008%20Fisk-Lee%206676%20Washington%20Paper%20Corrected%20May%206,%202008.pdf>. IRC § 6676 was added by Pub. L. No. 110-28, § 8247, 121 Stat. 112, 204 (2007). It does not apply where the accuracy-related penalty under section 6662 applies. IRC § 6676(d).

18 *Rand v. Comm’r*, 141 T.C. 376, 395 (2013).

However, section 6676 does not include a reasonable cause exception.¹⁹ Rather, it provides an exception where there was a “reasonable basis” for the claim.²⁰ Neither section 6676 nor the regulations under that section define “reasonable basis,” but a regulation under section 6662 provides in pertinent part:

Reasonable basis is a relatively high standard of tax reporting, that is [sic], significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities set forth in § 1.6662-4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard ...²¹

In the years following enactment of section 6676, means-tested refundable credits proliferated.²² As noted above, however, the IRS continued to assert the accuracy-related penalty on disallowed refunds under section 6662 rather than asserting the penalty under section 6676.²³ In 2013, the Tax Court in *Rand v. Commissioner* interpreted the definition of “underpayment” in the Treasury regulations under section 6664 and held that the “amount shown as tax on the return” takes into account the EITC, additional child tax credit, and recovery rebate credit, but these refundable credits do not reduce the amount shown as tax below zero.²⁴ Thus, these erroneously claimed credits may be subject to an accuracy-related penalty under section 6662 only to the extent they reduced a tax liability. Except for disallowed EITC, they may be subject to the penalty under section 6676 to the extent they generated a refund.²⁵ While section 6676 may have filled a perceived gap in the penalty framework, it was not clear until 2013 that some disallowed refundable credits could *only* be penalized pursuant to section 6676, rather than pursuant to section 6662.

19 As originally proposed, the new penalty contained a reasonable cause exception. See Dept. of Treas., *Gen. Explanations of the Admin’s FY 2008 Rev. Proposals* (Feb. 2007) at 82, available at <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2008.pdf>. After enactment, the IRS Office of Chief Counsel, Procedure and Administration, recommended adding a reasonable cause exception to the section 6676 penalty in its suggestions for the U.S. Department of the Treasury’s FY 2012 Green Book, which provides explanations of the Administration’s fiscal year revenue proposals.

20 IRC § 6676(a).

21 Treas. Reg. § 1.6662-3(b)(3). The authorities set forth in the cited Treas. Reg. § 1.6662-4(d)(3)(iii) include “[a]pplicable provisions of the Internal Revenue Code and other statutory provisions; proposed, temporary and final regulations construing such statutes; revenue rulings and revenue procedures; tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties; court cases; congressional intent as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, and floor statements made prior to enactment by one of a bill’s managers; General Explanations of tax legislation prepared by the Joint Committee on Taxation (the Blue Book); private letter rulings and technical advice memoranda issued after October 31, 1976; actions on decisions and general counsel memoranda issued after March 12, 1981 (as well as general counsel memoranda published in pre-1955 volumes of the Cumulative Bulletin); Internal Revenue Service information or press releases; and notices, announcements and other administrative pronouncements published by the Service in the Internal Revenue Bulletin.” The list of authorities does *not* include IRS publications or instructions to IRS forms—materials average individual taxpayers would consult and rely on in preparing their returns—or even legal opinions or opinions of tax professionals.

22 Credits that were enacted or made refundable after 2007 include the first-time homebuyer credit (IRC § 36), the making work pay credit (IRC § 36A), the premium tax credit (IRC § 36B), the adoption credit (IRC § 23), the American opportunity tax credit (IRC § 25A), and the recovery rebate credit (IRC § 6428).

23 According to the Treasury Inspector General for Tax Administration (TIGTA), the IRS assessed only 84 erroneous refund penalties totaling \$1.9 million between May 2007 and May 2012. TIGTA, Ref. No. 2013-40-123, *The Law Which Penalizes Erroneous Refund and Credit Claims Was Not Properly Implemented* (Sept. 26, 2013), available at <http://www.treasury.gov/tigta/auditreports/2013reports/201340123fr.html>.

24 For a complete discussion of the *Rand* case, see Most Litigated Issue: *Accuracy-Related Penalty Under IRC § 6662(b)(1), (2), and (3)*, *infra*.

25 *Rand v. Comm’r*, 141 T.C. 376, 395 (2013). As noted above, at least one congressional bill proposes removing the exclusion for EITC under section 6676. See H.R. 5070, 113th Cong., 2d Sess. § 6 (July 10, 2014).

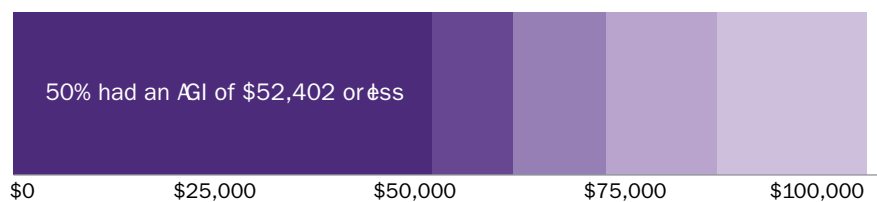
On June 10, 2014, the IRS adopted the TBOR. Among taxpayer rights is the *right to a fair and just tax system*, which includes taxpayers' "right to expect the tax system to consider facts and circumstances that might affect their underlying liabilities, ability to pay, or ability to provide information timely."²⁶

REASONS FOR CHANGE

Unlike the "reasonable cause" exception to liability under section 6662, the "reasonable basis" standard under section 6676 does not appear to require the IRS to take into account all the facts and circumstances, including the taxpayer's knowledge and experience with tax law and his or her efforts to comply with the law, and is thus inconsistent with taxpayers' right to a fair and just tax system. Section 6676 appears to contemplate a sophisticated taxpayer with access to technical authorities on which to construct a return position, who then disregards those authorities. Taxpayers who claim the benefits of at least one social program delivered through refundable tax credits, the additional child tax credit, do not generally fit this description. To begin with, as Figure 2.8.1 shows, half the 2012 returns on which taxpayers claimed the child tax credit that generated a refund showed adjusted gross income (AGI) under \$53,000.²⁷

FIGURE 2.8.1

**Adjusted gross income shown on 2012 returns claiming
Additional Child Tax Credit that generated a refund, by percentile**



Taxpayers who claimed the additional child tax credit and whose refunds were then disallowed were even worse off. Of these taxpayers, half the 2012 returns showed adjusted gross income under \$22,000.²⁸

26 Taxpayer Bill of Rights, available at <http://taxpayeradvocate.irs.gov/About-TAS/Taxpayer-Rights#rights>.

27 TAS Research, based on data from the Individual Returns Transaction File (IRTF) on the IRS Compliance Data Warehouse (CDW), for tax year 2012 taxpayers claiming the additional child tax credit and a refund. The data for 2013 returns is similar, with AGI at the 50th percentile equal to \$52,714.

28 TAS Research, based on data from the IRTF and Exam Operational Automation Database on CDW, for tax year 2012. According to the Department of Health and Human Services, the 2014 poverty guideline for a four-person household in the 48 contiguous states and the District of Columbia is \$23,850. Dept. of Health and Human Services, Annual Update of the Poverty Guidelines, 79 Fed. Reg. 3593-3594 (Jan. 22, 2014), available at <http://aspe.hhs.gov/poverty/14poverty.cfm>.

FIGURE 2.8.2

**Adjusted gross income shown on 2012 returns claiming
Additional Child Tax Credit where refund was disallowed, by percentile**



Moreover, taxpayers who erroneously claim refundable credits are subject to different standards depending on unrelated characteristics of their returns. A taxpayer who erroneously claims a refundable credit that reduces his or her tax liability but does not generate a claim of refund would be subject to the penalty under section 6662, but could avoid the penalty by demonstrating reasonable cause. A different taxpayer who erroneously claims the same refundable credit, where the credit not only reduces his or her tax liability but also results in a claim of refund, would be subject to the penalty under section 6676, and could avoid the penalty only by showing “reasonable basis” for the claim.

EXPLANATION OF RECOMMENDATION

The proposal would amend section 6676 to clarify that the penalty does not apply to individual taxpayers who acted with reasonable cause and in good faith in erroneously claiming a credit or refund. Taking into account all of taxpayers’ facts and circumstances in determining whether they had such reasonable cause would bring this statutory penalty into conformity with the TBOR right to a fair and just tax system. This approach reflects recent judicial interpretations of sections 6662 and 6676, is consistent with the accuracy-related penalty provisions of section 6662, avoids subjecting unsophisticated taxpayers to a penalty intended to reach taxpayers who take calculated risks in their reporting positions, and permits consistent treatment of similarly situated taxpayers.