

# Taxpayers Should Prepare For The Next Penalty Battleground

By **Andrew Roberson, Kevin Spencer and Evan Walters**

During a tax audit, taxpayers and the Internal Revenue Service often disagree on the tax treatment of one or more items reported on a tax return. Similarly, they may disagree on whether claims for credits or refund are correct. Most disagreements are resolved by the parties, but resolution is more difficult when penalties are on the table. This article focuses on the Internal Revenue Code Section 6676 penalty for disallowed refund claims, which the IRS is starting to assert more frequently.

## Background

Penalties can take many forms, the most common of which is the so-called “accuracy-related” penalty under IRC Section 6662.[1] This penalty, which can be asserted based upon various grounds — e.g., negligence, disregard of rules or regulations, substantial understatement of tax, valuation misstatements, etc. — equals 20% of underpayments of tax and is increased to 40% in certain situations.

Taxpayers have several potential defenses to the accuracy-related penalty depending on the ground upon which the penalty is asserted, including “substantial authority,” “reasonable basis,” adequate disclosure,” “reasonable cause” and good faith. Because the accuracy-related penalty is calculated based on the tax underpayment amount — i.e., the difference between the amount that should have been reported on the return and the amount that was reported on the return — taxpayers usually have the right to challenge the penalty in the U.S. Tax Court without first paying the penalty.

But, the IRC Section 6662 penalty cannot be asserted when a taxpayer files a claim for refund or credit because there is no tax deficiency by which the accuracy-related penalty could be calculated. That is where IRC Section 6676 comes in.[2] It punishes taxpayers who seek refunds in amounts larger than what the IRS deems allowable through a penalty equal to 20% of the disallowed refund claim amount.

## The Origins of IRC Section 6676

IRC Section 6676 was enacted in 2007.[3] The legislative history is sparse, but the statute appears to have been enacted in response to reports by the Treasury Inspector General for Tax Administration and the Joint Committee on Taxation, both of which informed Congress of the high number of meritless refund claims which strained IRS resources and created impediments to effective tax administration.[4] Both TIGTA and the JCT discussed “refund schemes,” mostly fraudulent, that resulted in the erroneous issuance of refunds and a high level of lost revenue to the fisc.

IRC Section 6676(a) imposes a 20% penalty to the extent that a claim for refund or credit with respect to income tax is made for an “excessive amount.”[5] An “excessive amount” is defined as the difference between the amount of the claim for credit or refund sought and the amount that is actually allowable.[6] For example, if the taxpayer claims a refund of \$2



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million and the IRS allows only \$1 million, the taxpayer can be penalized \$200,000 pursuant to IRC Section 6676.

Significantly, IRC Section 6676 does not require the IRS to show any fault or culpability on the part of the taxpayer — e.g., negligence, disregard of rules or regulations, etc. Indeed, IRC Section 6676(a) originally provided a “reasonable basis” defense. However, in 2015 Congress amended the statute to require “reasonable cause,”<sup>[7]</sup> which as discussed below can raise privilege concerns. Congress did not specify an effective date for the amendment, but the IRS has advised that the reasonable cause standard became effective for claims for refund or credit filed after Dec. 18, 2015, the date Congress amended the statute.<sup>[8]</sup> Neither the code nor the regulations provide for any other defense to the IRC Section 6676 penalty.

IRC Section 6676 — both in prior and current form — does not define “reasonable cause.” Treasury Regulation Section 1.6664-4 does, however, identify facts and circumstances which should be taken into account in determining whether a taxpayer had reasonable cause for taking a position.<sup>[9]</sup> Reasonable reliance on the advice of counsel, for instance, can establish reasonable cause under Treasury Regulation Section 1.6664-4. In general, where the same word or phrase appears multiple times in the Internal Revenue Code, it is presumed to have the same meaning each time.<sup>[10]</sup> Moreover, prior to the amendment of IRC Section 6676, the IRS relied on the IRC Section 6662 regulations for purposes of the “reasonable basis” defense.<sup>[11]</sup> Thus, the meaning of the term “reasonable cause” in the current version of IRC Section 6676(a) should be construed under the standards set forth in Treasury Regulation Section 1.6664-4.

Notwithstanding the above, the reasonable cause defense is not available if any excessive amount is attributable to a transaction lacking economic substance within the meaning of IRC Section 7701(o).<sup>[12]</sup>

### **Privilege Concerns**

Asserting the reasonable cause defense brings with it privilege concerns, because typically raising this defense results in the waiver of the privilege. Reasonable cause can be established by reasonable reliance on the advice of counsel, which puts into contention the state of mind of the taxpayer and could require a review of the materials considered — even if not relied upon — by the taxpayer.<sup>[13]</sup> Thus, in order to defeat the assertion of the IRC Section 6676 penalty, it may be necessary for taxpayers to both waive any applicable attorney-client and work product privileges and produce to the IRS any and all tax advice that was considered in the decision to claim a refund or credit.

Taxpayers and their counsel need to be extremely careful in documenting the basis for a claim for refund or credit in the event that the IRS asserts the IRC Section 6676 penalty and the taxpayer is required to assert a reasonable cause defense.

### **Contesting the IRC Section 6676 Penalty**

In April 2019, the IRS updated many of the Internal Revenue Manual provisions relating to IRC Section 6676. The Internal Revenue Manual explains that when the IRS determines that the IRC Section 6676 penalty should be imposed, the IRS examiner will explain the issue to the taxpayer and will offer the taxpayer a meeting with the IRS examiner’s manager to discuss the issue.<sup>[14]</sup> Written supervisory approval of the penalty is required pursuant to IRC Section 6751(b)(1).<sup>[15]</sup>

If the IRS maintains the position that the penalty applies, it will issue a 30-day letter permitting the taxpayer to seek review of the matter with the IRS Appeals Office.[16] If resolution cannot be reached at the IRS Appeals level, the next step is litigation.

Unlike the IRC Section 6662 accuracy-related penalty — described above, which can be challenged in Tax Court before it is paid, the IRC Section 6676 penalty is immediately assessable. This means that, once the IRS determines that the penalty applies, it can assess the penalty, issue a notice and demand for payment of the IRC Section 6676 penalty, and, if not paid within 30 days, begin the steps necessary to file a lien or levy against a taxpayer's property.[17] This can occur before any court has the opportunity to determine if the IRS is correct!

It should be noted that when the excessive amount of a refund claim is dependent on the determination of a tax deficiency— i.e., in a frozen refund situation where a refund has been claimed on the original return but had not been paid by the IRS — the IRS takes the position that the penalty is subject to the deficiency procedures, giving the taxpayer the ability to seek redress before paying the penalty in Tax Court.[18]

Taxpayers must generally challenge the IRC Section 6676 penalty in a tax refund court. This requires paying the penalty amount, filing a claim for refund with the IRS, and — assuming the claim is denied or the requisite six-month period has elapsed — filing a complaint in the appropriate U.S. District Court or the U.S. Court of Federal Claims seeking a refund of the penalty amount.[19]

### **IRC Section 6676 Is the IRS's Favorite New Compliance Tool**

To date, there have been no reported opinions specifically addressing the application of IRC Section 6676 or the reasonable cause defense thereto.[20] Moreover, no regulations have been promulgated under IRC Section 6676. For several years, the U.S. Department of the Treasury's Priority Guidance Plan identified the promulgation of IRC Section 6676 regulations as a priority item, but it removed the issue from the list in 2015.

The lack of published guidance on IRC Section 6676 after over a decade of the provision's enactment suggests that the IRS has utilized this penalty provision sparingly in the past. However, recent informal IRS guidance, audit activity and pending litigation indicate that IRC Section 6676 may become the IRS's new favorite compliance tool.[21]

In a Large Business and International Division directive issued on Nov. 21, 2018,[22] the IRS advised its personnel to consider, when appropriate, the application of IRC Section 6676 to claims for refund premised upon IRC Section 199. Given that IRC Section 199 was removed from the Internal Revenue Code as part of the Tax Cuts and Job Act enacted in late 2017, many taxpayers are likely considering or have filed claims seeking refund pursuant to IRC Section 199. The IRS therefore likely wants to ensure that such claims have both a factual and legal basis, and intends to penalize taxpayers who overreach by inflating their refund claims in the wake of tax reform.

In IRS chief counsel advice memorandum 201727004,[23] the IRS responded to a request relating to the treatment of a regulated investment company or a real estate investment trust that files a deficiency dividends claim under IRC Section 860.[24] The advice was primarily focused on whether certain penalties relating to understatements of tax might apply. However, the IRS included a brief discussion of IRC Section 6676 because the allowance of a deduction for deficiency dividends could, in some situations, result in an overpayment of tax. The IRS noted that the liability for the penalty would depend on the

merits of the refund claim and, assuming the claim were disallowed, whether the taxpayer could establish reasonable cause for making the excessive claim.

In CCA 201640016,[25] the IRS considered issues related to fraud and the IRC Section 6676 penalty for claimed refunds based on overstated withholding. The memorandum noted that for one of the years there would be no underpayment and therefore the IRC Section 6673 fraud penalty was inapplicable. It concluded, however, that “[t]he appropriate penalty for this type of situation — where the taxpayer makes a false claim for refund that is not paid — is the [IRC] Section 6676 penalty on erroneous claims for refund.”

As the recent guidance suggests, the IRS has been more aggressive of late in asserting the Section 6676 penalty against taxpayers in ongoing audits. We are seeing the IRS assert this penalty with more frequency. For example, there is pending litigation in U.S. District Court involving disallowed refund claims in which the IRS has asserted a significant IRC Section 6676 penalty.[26] In that case, the IRS assessed an IRC Section 6676 penalty and the parties, in addition to fighting over the substantive issue, disagree on whether the IRC Section 6676 penalty applies.

## **Conclusion**

The IRS is using a new tool from its arsenal to force tax compliance for tax refund claims. IRC Section 6676 is a 20% penalty that the IRS can assert for any amount of a claim for refund or credit to which the taxpayer is not entitled. The penalty is immediately assessable, and typically taxpayers will have to pay the penalty, file a formal refund claim for the penalty, and sue in court for a refund. A taxpayer, however, can abate the penalty if it can show it had reasonable cause for its position. Taxpayers who are considering filing, or have already filed, refund claims should ensure that they have sufficient documentation to support their claim and establish reasonable cause should any amount of the claim be disallowed.

Of course, asserting reasonable cause is a strategic decision that can come with the price of waiving any privilege that may exist in the advice upon which the taxpayer relied in making the refund claim. Recent audit activity shows that the IRS is asserting the IRC Section 6676 penalty with much greater frequency, and taxpayers and their advisers need to be aware of the mechanics of this penalty and how best to avoid it being sustained.

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[1] IRC Section 6662. 

[2] IRC Section 6676. 

[3] Small Business and Tax Act of 2007, Pub. L. No. 110-28, § 8247.


[4] See Treasury Inspector General for Tax Administration, Semiannual Report to Congress (Apr. 1, 2005 through Sept. 30, 2005), available at [https://www.treasury.gov/tigta/semiannual/semiannual\\_dec2005.pdf](https://www.treasury.gov/tigta/semiannual/semiannual_dec2005.pdf); Staff of Joint Committee on Taxation, Description of Revenue Provisions Contained in the President's Fiscal Year 2008 Budget Proposal, JCS-2-07 (Mar. 2007).


[5] IRC Section 6676(a) .

[6] IRC Section 6676(b) .


[7] Protecting Americans from Tax Hikes Act of 2015, Pub. L. No. 114-113, § 209(c)(3), Div. Q. In addition, as originally enacted, IRC Section 6676 did not apply to disallowed claims relating to the earned income credit. However, Congress removed this limitation as part of the 2015 amendments to IRC Section 6676.

[8] CCA 201640016 (Sept. 30, 2016), at footnote 2.

[9] Treasury Regulation § 1.6664-4 .

[10] *Atlantic Cleaners & Dyers Inc. v. U.S.* , 286 U.S. 427, 433 (1932); *TG Mo. Corp v. Comm'r*, 133 T.C. 278, 296 (2009). For a more detailed discussion of rules of construction, see Roberson & Jones, "Rules of Construction Provide Framework for Decoding TCJA," *Law360* (Feb. 28, 2019) (available at <https://www.law360.com/articles/1133530/rules-of-construction-provide-framework-for-decoding-tcja>).

[11] P.M.T.A. 2010-03 (Feb. 26, 2010).

[12] IRC Section 6676(c)  (referencing IRC Section 6662(b)(6) transactions); see also IRS Notice 2014-58, 2014-44 I.R.B. 746 (Oct. 9, 2014) ("For purposes of the penalty for an erroneous claim for refund or credit of an excessive amount, section 6676(c) provides that any excessive amount (within the meaning of section 6676 (b)) that is attributable to any transaction described in IRC section 6662(b)(6) is treated as not having a reasonable basis [now required to having reasonable cause].")

[13] *Ad Investment 2000 Fund LLC v. Comm'r* , 142 T.C. 248 (2014).

[14] IRM 20.1.5.18.5(8) (04-22-2019).

[15] IRM 20.1.5.18.4(4) (04-22-2019).

[16] IRM 20.1.5.18.5(10) (04-22-2019).

[17] See, e.g., *Kahanyshyn v. Comm'r*, Tax Court Dkt. No. 29697-14 (Order dated Sept. 4, 2015) ("The section 6676 penalty is an assessable penalty under subchapter B of chapter 68 that is not subject to the deficiency procedures.").

[18] IRM 20.1.5.4(1) (April 22, 2019). The refund claim for the IRC Section 6676 penalty is usually filed on Form 843, Claim for Refund and Request for Abatement. See IRM 20.1.5.18.7(3) (12-13-2016).

[19] 28 U.S.C. § 1346  (providing U.S. District Court jurisdiction); 28 U.S.C. §

1491 (providing U.S. Court of Federal Claims jurisdiction). IRC Section 6330(d)(1) grants the Tax Court jurisdiction to review taxes, including assessable penalties, in the context of a Collection Due Process, or CDP, case. CDP refers to proceedings in which the taxpayer may challenge the appropriateness of the IRS's collection efforts, for example, by challenging the amount of the underlying liability or the denial of collection alternatives such as an "offer in compromise" or an installment agreement. However, a taxpayer may not challenge, and the Tax Court may not review, the existence or amount of the underlying liability during a CDP proceeding unless the taxpayer had no prior opportunity to contest the liability. This happens only in rare circumstances because an opportunity for a conference with the IRS Appeals Office constitutes an opportunity to contest a liability. Accordingly, because the taxpayer is typically entitled to seek an IRS appeal of the IRC Section 6676 penalty, if the taxpayer seeks redress in Tax Court under the CDP mechanism, the court will likely not entertain a challenge to the underlying basis for the penalty. See *Our Country Home Enterprises Inc. v. Comm'r*, 855 F.3d 773 (7th Cir. 2017); *Keller Tank Services II Inc. v. Comm'r*, 854 F.3d 1178 (10th Cir. 2017); *James v. Comm'r*, 850 F.3d 160 (4th Cir. 2017); *Lewis v. Comm'r*, 128 T.C. 48 (2007).

[20] However, there are a few unreported opinions. See, e.g., *United States v. Thomas*, No. 3:14-cv-318, 2015 WL 1324379 (N.D. Ohio Feb. 17, 2015).

[21] In 2009, the IRS directed that the IRC Section 6676 penalty be addressed in all cases where research credit claims are disallowed in whole or in part. See LMSB-4-0608-035 (Jan. 15, 2009).

[22] LB&I-04-1118-016, LB&I Directive on Amended Return/Claim for Refund Relating to Internal Revenue Code Section 199 (Nov. 21, 2018), available at <https://www.irs.gov/businesses/lbi-directive-on-amended-return-or-claim-for-refund>; see also IRS Practice Unit, IRC 179D Energy Efficient Commercial Buildings Deduction (Jan. 28, 2019), available at [https://www.irs.gov/pub/irs-utl/dce\\_p\\_250\\_05\\_01.pdf](https://www.irs.gov/pub/irs-utl/dce_p_250_05_01.pdf) (instructing IRS personnel to consider whether to apply penalties, including the Section 6676 penalty, if an adjustment to a Section 179D deduction results in a tax adjustment).

[23] IRS chief counsel advice memorandum 201727004 (July 7, 2017).

[24] IRC Section 860.

[25] CCA 201640016 (Sept. 30, 2016).

[26] See Olivo, Natalie, "IRS Defends Response In Exxon \$1.35B Refund Case" (Sept. 20, 2017) <https://www.law360.com/articles/965950/irs-defends-response-in-exxon-1-35b-refund-case>; Rosen, Amy Lee, "Exxon Seeks To Argue IRS Lacked Approval For \$200M Penalty" (Nov. 28, 2018) <https://www.law360.com/tax-authority/articles/1105674/exxon-seeks-to-argue-irs-lacked-approval-for-200m-penalty>.