IRS Wrongly Ignores the 20 Percent Excessive Refund Penalty

By Carlton M. Smith


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In this article, the author discusses a dispute over whether the accuracy-related penalty of section 6662 can apply to refundable credit disallowances. He also explores the interplay between section 6662 and the rarely asserted section 6676 excessive refund penalty, and he makes proposals to better coordinate the two penalties with the procedures for assessing the taxes related to the penalties.

There's something odd going on. In 2007 Congress enacted, at section 6676, a new 20 percent penalty on excessive refunds received by taxpayers. I represent low-income taxpayers all the time who have, according to the IRS, received excessive refunds. But I have never seen the IRS assert the section 6676 penalty against those taxpayers. Why?

As far as I can tell, the IRS simply sees the penalty as unnecessary because it thinks it can already get a 20 percent section 6662 accuracy-related penalty in nearly every income tax case in which it could get the section 6676 penalty. In my view, the IRS has badly overconstrued the scope of the section 6662 penalty by applying it to disallowed refundable tax credits and as a result, has since 1989 improperly sought from the working poor roughly half a million section 6662 penalties on the disallowance of those credits — perhaps as much as $300 million in penalties. Along with others, I contend that (1) the section 6676 penalty is the only proper way to impose civil penalties on excessive refunds relating to most refundable credits, and (2) there is no 20 percent civil penalty — or 75 percent fraud penalty — on excessive refunds attributable to earned income tax credits.

One test case in the Tax Court, *Rand v. Commissioner*,[1] is challenging the IRS's reading of how the section 6662 penalty applies to refundable credit disallowances. More *Rand*-type cases are sure to follow.

This article explains what is being argued by both sides in *Rand*. Regardless of what the Tax Court decides in that case, I would much prefer that Congress step in and prospectively (1) integrate the section 6676 penalty into an expanded section 6662 penalty for credit disallowances that are subject to the deficiency procedures and (2) make the section 6676 penalty applicable only to credit disallowances that are not subject to the deficiency procedures (but with an added 75 percent fraud component in the section 6676 penalty). That would clarify the law and limit litigation on this issue to the pre-amendment tax years.

How 'Deficiency' Includes Refundable Credits

A limited number of credits are refundable — that is, they can generate refund checks even though the taxpayer never paid anything to the IRS. Refundable credits include the EITC at section 32, the additional child tax credit (ACTC) at section 24(d), and some health insurance credits at sections 35 and 36B. Although we don't usually think of them as refundable credits, section 31 provides a refundable credit in the amount of the income tax withheld on wages, and section 33 provides a refundable credit in the amount of the income tax withheld at source on some U.S.-source income of nonresident aliens and foreign corporations.

In creating the Tax Court's predecessor in 1924, the Board of Tax Appeals, Congress provided a way for taxpayers to challenge IRS-proposed deficiencies in income, estate, gift, and some excise taxes before payment thereof. The IRS would issue the taxpayer a notice of deficiency for those taxes under section 6212, and the taxpayer could petition the court under section 6213(a) to redetermine the deficiency. Only after the court case was over could the IRS assess and begin collecting the tax by issuing a notice and demand for it. For some other taxes, however — including the FICA taxes at sections 3101 and 3111 — Congress did not want to make a prepayment judicial challenge possible. For those, a taxpayer could contest an IRS-proposed tax only after assessment. That was generally done by paying the full tax, filing a refund claim, and if the claim was denied, bringing a refund suit in either the local district court or the Court of Federal Claims in Washington.

By the mid-1970s there were only two common refundable credits beyond the section 31 and 33 credits for withheld taxes: the EITC and the credit for some uses of gasoline and special fuels.[2] When the refundable EITC and fuel credit were enacted,

[1]No. 2633-11 (filed Feb. 7, 2011).

[2]The fuel credit, originally provided under section 39, has been relocated to section 34.

Congress wavered over which procedure should apply for assessing and collecting amounts attributable to erroneous claims of those credits. It initially decided to give the IRS the rather Draconian power to simply assess back erroneous EITC and fuel tax credits under a provision located at section 6201(a)(4). Thus, the credits would be assessed back by notice and demand, and a taxpayer could challenge the disallowance only through the refund route. This was particularly harsh because it predated the enactment of the collection due process provisions, which allow taxpayers to challenge the amount of a direct assessment in the Tax Court before paying the assessment.[3]

But Congress eventually changed its mind and decided that except for some mathematical and clerical errors in claiming EITCs (such as the use of an incorrect Social Security number for a child[4]), taxpayers should be entitled to fight the disallowance of EITCs and fuel tax credits before paying the resulting assessment, through the Tax Court's jurisdiction to redetermine deficiencies. So in 1988 Congress repealed section 6201(a)(4) and amended the definition of deficiency in section 6211 to make the term encompass refundable credit disallowances.[5] From then on, if the issue was, say, whether the taxpayer resided with the child for more than half the year,[6] that question could be the subject of a prepayment Tax Court deficiency suit that preceded the IRS's assessment of the taxes attributable to disallowing the EITC.

Before 1988, a deficiency was essentially defined under section 6211(a) as the excess of the tax imposed (that is, the correct tax) over the amount shown as the tax on the taxpayer's return. To have the definition address refundable credits, Congress added new section 6211(b)(4), which provided:

> 4. For purposes of subsection (a) —
>
> A. any excess of the sum of the credits allowable under sections 32 and 34 over the tax imposed by subtitle A (determined without regard to such credits), and
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> B. any excess of the sum of such credits as shown by the taxpayer on his return over the amount shown as the tax by the taxpayer on such return (determined without regard to such credits),
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> shall be taken into account as negative amounts of tax.

As additional refundable credits were added to the code in later years, section 6211(b)(4) was eventually expanded to cover all refundable credits, not just the EITC and fuel tax credits.

To see how section 6211(b)(4) works, let's look at a simplified variation of the facts of *Rand*. Assume that for 2008, taxpayers had two children, but only $2,000 of self-employment income and reported $15,000 of wages. They reported taxable income of $0 and income tax liability of $0. However, they did report $283 of self-employment tax on the self-employment income. Against that self-employment tax, the taxpayers claimed an ACTC of $1,254, an EITC of $4,824, and a recovery rebate credit of $1,200 under section 6428. After subtracting the $283 of tax from those refundable credits, the IRS sent the hypothetical couple a refund check for $6,995.

The IRS later issued a notice of deficiency recharacterizing all of the income (other than the $2,000 of self-employment income) as not earned income. Thus, the couple still owed no income tax but had to pay $283 of self-employment tax. The IRS disallowed for lack of sufficient earned income all of the ACTC, EITC, and recovery rebate credit that the taxpayers claimed. Each of those credits required some earned income as a predicate. The IRS asserted a deficiency of $7,278 — the amount of the improperly taken refundable credits.

I am unsure how the IRS computed the deficiency in *Rand*, but here is how I would do it in my hypothetical example.

First, the tax imposed (if there are no allowable credits) is only the $283 of self-employment tax. Second, the amount shown as the tax by the taxpayers on their return should have been $0 (without considering the special rule of section 6211(b)(4) on refundable credits) — that is, $283 of tax less credits sufficient to reduce that amount down to $0.[7] The excess of the first number over the second is $283 of deficiency. But now let's apply the section 6211(b)(4) rule to modify the amount shown as the tax on the taxpayer's return.

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[3]*See* section 6330(d).

[4]*See* section 6213(g)(2)(F).

[5]Section 1015(r)(2) of the Technical and Miscellaneous Revenue Act of 1988.

[6]*See* section 32(c)(3), which incorporates most of the rules for a qualifying child under section 152(c).

[7]In *Martz v. Commissioner*, 77 T.C. 749 (1981), the Tax Court said that the term ''tax'' in section 6211(a) meant the subtitle A income tax after reduction for all credits. However, the case involved only a nonrefundable credit, the since-repealed investment tax credit. In *Martz*, the Tax Court said that the only credits that were not subtracted from the section 1 and section 1401 subtitle A taxes for purposes of computing a deficiency were the refundable credits for tax withholding at sections 31 and 33 because a specific statutory provision at section 6211(b)(1) so provided.

Section 6211(b)(4)(B) provides that the excess of the refundable credits (here $7,278) over the tax shown by the taxpayers on their return determined without regard to the refundable credits ($283) is taken into account as a negative amount of tax for purposes of subsection (a). That excess is a negative amount of tax of $6,995 (the amount of the refund check). Thus, the amount shown as the tax by the taxpayers on their return is reduced by section 6211(b)(4) to negative $6,995.

The deficiency, according to my computation, is therefore the amount by which the $283 of tax imposed (allowing no credits) exceeds negative $6,995 — that is, $7,278 (not surprisingly, the amount of the refundable credits).

The *Rand* taxpayers have conceded that they owe a deficiency in tax equal to the amount of the disallowed refundable credits, as per the IRS's notice of deficiency. What they dispute is the notice of deficiency's inclusion of a section 6662 penalty equal to 20 percent of the deficiency. The couple's primary contention is that there can be no such penalty because there is no underpayment under section 6664(a) to which the 20 percent may apply.

'Underpayment' Decoupled From 'Deficiency'

Before 1989, there had long been a negligence penalty at former section 6653(a) and a fraud penalty at former section 6653(b). Under former section 6653(c), the penalties were percentages (that is, 5 and 50 percent, respectively) of an amount called an ''underpayment'' that was derived from the definition of deficiency in section 6211.

In 1989, as part of a consolidation and rewriting of the civil penalty sections applicable to inaccurate returns, Congress repealed former section 6653 and enacted a new definition of underpayment at section 6664(a). On those underpayments, the IRS would impose the new section 6662 accuracy-related penalty (at rates of 20 or 40 percent) and the section 6663 fraud penalty (at a rate of 75 percent). The section 6664(a) definition of underpayment is an edited version of the section 6211(a) definition of deficiency — one that does not contain some of the provisions that are in section 6211(b). Two provisions missing from the section 6664(a) definition of underpayment are those analogous to the special rule about withholding credits in section 6211(b)(1) and the special rule for refundable credits creating negative amounts of tax in section 6211(b)(4). In essence, however, the definition of underpayment was otherwise left unchanged, so that the underpayment was generally the excess of the tax imposed over ''the amount shown as the tax by the taxpayer on his return.'' This last phrase was almost identical to the language in section 6211(a).[8]

The question today is how far Congress's decoupling of the definition of underpayment in section 6664(a) (for purposes of the new penalties under sections 6662 and 6663) from the definition of deficiency (for purposes of section 6211) was intended to go.

In 1991 the IRS adopted a regulation making several modifications to the definition of underpayment in section 6664(a).

First, reg. section 1.6664-2(b)(1)[9] instructed that withholding credits under sections 31 and 33 are not to be counted in computing the underpayment. That is similar to the rule found in section 6211(b)(1) for deficiencies.

Second, reg. section 1.6664-2(c)(1) extended the meaning of underpayment to include a taxpayer's overstatements of withholding, estimated tax payments, and tax payments. In *Feller v. Commissioner*[10] the Tax Court upheld the validity of this regulatory provision, even though there is no comparable provision in section 6211.

Third, reg. section 1.6664-2(c)(2) provided that ''the amount shown as the tax by the taxpayer on his return'' includes amounts of tax shown on qualified amended returns. That allowed taxpayers to come forward with amended returns reporting additional tax on which the IRS would not impose the accuracy-related penalty if the amended returns were filed before the IRS made the first contact for an audit.

Oddly, what the IRS did not do in 1991 or any time thereafter was add a provision analogous to section 6211(b)(4) that would treat excess refundable credits as negative amounts of tax for purposes of the section 6664(a) definition of underpayment.

Despite its failure to amend the regulation to make that modification for refundable credits (which might or might not survive *Chevron* step one[11] scrutiny under *Mayo*[12]), the IRS has acted since 1989 as though there is such a provision in either section 6664(a) or the regulation thereunder.

As National Taxpayer Advocate Nina Olson noted in 2001, in tax year 2000 alone, the IRS issued 17,300 notices of deficiency disallowing EITCs and asserting either the 20 percent accuracy-related penalty of section 6662 or the 75 percent fraud penalty

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[8]The only change is that the word ''upon'' from section 6211(a) was modernized to ''on'' in section 6664(a).

[9]Adopted by T.D. 8381.

[10]135 T.C. 497 (2010), *Doc 2010-24040*, *2010 TNT 216-16*.

[11]*Chevron U.S.A. Inc. v. N.R.D.C. Inc.*, 467 U.S. 837 (1984).

[12]*Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 704 (2011), *Doc 2011-609*, *2011 TNT 8-10*.

of section 6663 on those disallowances.[13] The EITC is only one of the refundable credits as to which the IRS thinks it may impose the section 6662 and 6663 penalties when disallowing them. If there have been roughly 20,000 notices of deficiency disallowing refundable tax credits and imposing accuracy-related or fraud penalties in each of the 24 years since 1989 (a plausible guess), there probably have been around half a million incorrect assertions of those penalties since then. If the average penalty amount proposed in those notices has been $600 (20 percent of my guesstimate of average total refundable credits of $3,000 per taxpayer in those notices), there probably have been around $300 million of incorrectly asserted section 6662 penalties — mostly against the working poor.

The Parties' Arguments in *Rand*

Rand is actually the fourth Tax Court case in which the propriety of imposing accuracy-related penalties on disallowed refundable credits has come up. However, it is apparently the first case in which the parties have briefed the issue.

In three prior summary opinions decided between 2001 and 2008,[14] three different Tax Court special trial judges noticed and raised the issue — apparently on their own. In those opinions, each judge held that even though a disallowed refundable credit could give rise to a deficiency under section 6211, no accuracy-related penalty could be imposed on the credit disallowances because there was no provision equivalent to section 6211(b)(4) in the section 6664(a) definition of underpayment.

The *Rand* taxpayers' primary argument is that the "tax" mentioned in section 6664(a) is only the tax imposed by sections 1 and 1401. They maintain that any credit disallowance simply cannot be part of an underpayment, since the correct tax and the tax shown on the return are not net of refundable credits. Thus, they primarily argue the underpayment is $0. In the alternative, the taxpayers argue that the tax shown on the return cannot be below zero, so the underpayment is only $283 in my hypothetical example.

In the IRS's view, however, the term "tax" in section 6664(a) is net of all credits, and the tax shown on the return can not only be reduced to $0, but also go below $0. So, the IRS argues that in my hypothetical example the tax imposed is $283, that the tax shown on the return is negative $6,995, and that the excess of the former over the latter (the underpayment) is $7,278.

IRS internal guidance has taken the position that in the section 6664(a) definition of underpayment, refundable credits can produce a negative amount of tax shown on the return — even without any provision in the statute or Treasury regulations dealing with refundable credits or negative amounts of tax. That guidance is not in a publicly issued revenue ruling or revenue procedure, but in several internal documents prepared by IRS National Office attorneys over the years.[15]

In the last two years, various low-income taxpayer clinicians have complained to the IRS of, at minimum, the impropriety of determining an underpayment on account of disallowed refundable credits when the refund check has not even been sent, but was frozen instead. On the very day the IRS filed its reply brief in *Rand*, May 30, 2012, the IRS issued PMTA 2012-016[16] modifying several of the examples in PMTA 2010-001 to agree with the clinicians that frozen refund checks improperly sought do not get penalized under section 6662 because there is no underpayment in that situation. The new guidance closes with a notice to the IRS campuses to look out for the opinion in *Rand* to see whether the Service's position will be rejected for cases in which the IRS has paid the refund.

The IRS's rationale for its interpretation of underpayment in section 6664 is summarized on page 6 of its opening brief in *Rand*:

> Respondent's interpretation of section 1.6664-2(c), Income Tax. Regs., is a reasonable interpretation of an ambiguous regulation and is entitled to *Auer* deference. The contrary interpretation offered by petitioners is not entitled to deference, and should be rejected because it is not consistent with congressional intent, in that it would lead to inconsistent application of penalties against similarly situated taxpayers and would deprive respondent of a critical tool in combating false tax returns.

The IRS argues that the phrase "the amount shown as the tax by the taxpayer on his return" appearing at reg. section 1.6664-2(c) is ambiguous regarding the treatment of refundable credits. In

[13]Nina Olson, "National Taxpayer Advocate 2001 Annual Report to Congress," at 90 (Dec. 31, 2001), *Doc 2002-305*, *2002 TNT 7-37*. The number of examination reports (*i.e.*, 30-day letters) asserting these penalties is unknown but likely vastly larger each year.

[14]*Solomon v. Commissioner*, T.C. Summ. Op. 2008-95, *Doc 2008-16847*, *2008 TNT 149-6*; *Quintero v. Commissioner*, T.C. Summ. Op. 2002-47, *Doc 2002-10805*, *2002 TNT 89-13*; and *Akhter v. Commissioner*, T.C. Summ. Op. 2001-20, *Doc 2001-6005*, *2001 TNT 41-14*.

[15]TAM 2841039058 (Mar. 21, 1998); SCA 200113028, *Doc 2001-9198*, *2001 TNT 63-40*; PMTA 2010-001, *Doc 2010-10442*, *2010 TNT 91-11*.

[16]*Doc 2012-17687*, *2012 TNT 163-18*.

Auer v. Robbins, 519 U.S. 452, 461 (1997), the Supreme Court held that in the absence of an unambiguous statute or regulation, courts must ''defer to an agency's interpretation of its regulations, even in a legal brief, unless the interpretation is plainly erroneous or inconsistent with the regulation or there is any other reason to suspect that the interpretation does not reflect the agency's fair and considered judgment on the matter in question.''[17]

I don't wish to make a long response to the IRS's argument in *Rand* here, but I do want to note two things.

First, the IRS seems to overlook *Gonzales v. Oregon*,[18] a later case in which the Supreme Court declined to apply *Auer* deference to the attorney general's interpretation of regulatory language that merely parroted the statute. The agency's expertise in interpreting its own regulation was not involved, because the only question was the meaning of the statute itself. Similarly, the language ''the amount shown as the tax by the taxpayer on his return'' in reg. section 1.6664-2(c) merely parrots the wording of section 6664(a), so *Auer* deference is inapplicable to any IRS interpretation of the same words in its regulation, even if the language is ambiguous.

Second, the IRS has apparently totally misunderstood the authority Congress has already given it elsewhere to impose 20 percent civil penalties on most refundable credit disallowances. That authority is located in section 6676, not section 6662.

The Section 6676 Excessive Refund Penalty

In 2007 Congress enacted at section 6676 a new 20 percent civil penalty applicable to improper claims for credit or refund of income taxes.[19] The penalty is not limited to refund claims attributable to refundable credit disallowances. It is intended to be easier for the IRS to impose than the section 6662 penalty. The section 6662 penalty is imposed under the deficiency procedures, which allow a prepayment Tax Court suit.[20] By contrast, a section 6676 penalty can be imposed by notice and demand without the issuance of a notice of deficiency.[21] The section 6676 penalty also does not require, as an initial matter, that the IRS show any kind of taxpayer fault, such as negligence or substantial understatement of tax. Nor can a taxpayer avoid the section 6676 penalty by any form of disclosure. Section 6676(a) simply provides:

> If a claim for refund or credit with respect to income tax (other than a claim for a refund or credit relating to the earned income credit under section 32) is made for an excessive amount, unless it is shown that the claim for such excessive amount has a reasonable basis, the person making such claim shall be liable for a penalty in an amount equal to 20 percent of the excessive amount.

Thus, the only exception to the penalty is through a showing of ''reasonable basis'' by the taxpayer. I assume that reasonable basis will be interpreted to be the same as the reasonable cause and good faith exception under section 6664(c), although I can't be sure of that. After all, to tax lawyers reasonable basis means a level of confidence in a position, and it is a defined term in the regulations under section 6662. And there is almost no case law under section 6676, because the IRS is so loath to assert that penalty.

Section 6676(b) defines excessive amount as ''the amount by which the amount of the claim for refund or credit for any taxable year exceeds the amount of such claim allowable under this title for such taxable year.'' This is a much simpler definition of the base of the penalty than the definition of underpayment in section 6664(a).

There are only two exceptions to the rules of section 6676(a). First, under subsection (d), section 6676 ''shall not apply to any portion of the excessive amount of a claim for refund or credit which is subject to a penalty imposed under part II of subchapter A of chapter 68'' — that is, the penalties under sections 6662, 6662A, and 6663. Second, under subsection (c), any excessive amount that is attributable to any non-economic-substance transaction described in section 6662(b)(6) is not treated as having a reasonable basis.

So if my reading of sections 6662 and 6664 is correct, in my hypothetical example the IRS can impose the 20 percent section 6662 penalty against the portion of the refundable credits that brings the combined sections 1 and 1401 tax of $283 down to $0. Unlike the taxpayers in *Rand*, I think that credits go into the tax computation in section 6664(a)'s definition of underpayment, but ''tax'' cannot go below zero absent some special statutory or regulatory provision allowing for negative amounts of tax.

Second, in my view, on the balance of the credits that actually generated the hypothetical claimed refund ($7,278), the IRS may impose the 20 percent section 6676 penalty on that amount minus the EITC of $4,824 on which a section 6676 penalty may never be imposed.

I also believe that that result is exactly what Congress had in mind when it drafted section 6676. Because taxpayers cannot be penalized under section 6662 to the extent refundable credits exceed the tax and produce an erroneous refund, Congress

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[17]*Chase Bank USA NA v. McCoy*, 131 S. Ct. 871, 880 (2011).
[18]546 U.S. 243 (2006).
[19]Section 8247(a), P.L. 110-28.
[20]Section 6665.
[21]Section 6671(a).

enacted an even easier-to-impose 20 percent penalty on the excess. But it did not want a 20 percent penalty imposed on EITC disallowances — under section 6662, 6663, or 6676 — on top of the money that was erroneously paid to the taxpayer and must be reimbursed. Congress apparently decided that the sanction it imposed at section 32(k) on people who incorrectly claim the EITC is a better sanction than simply adding on a 20 percent penalty against a low-income taxpayer who is probably unlikely to pay back the improper EITC or any penalty out of his own funds. Section 32(k) is actually a harsher sanction than a single 20 percent penalty. It provides that if there is a final determination that the taxpayer was reckless or intentionally disregarded the rules in claiming an EITC, the taxpayer may not be allowed an EITC in the next two years after the year of determination. For fraudulent conduct, the two-year disallowance period is extended to 10 years.

While the IRS may be able to point to individual lawmakers who may think the sections 6662 and 6663 penalties apply to refunds from EITCs, that does not appear to be what the code provides.

Although the IRS has ignored its authority under section 6676 — preferring instead to assert improper section 6662 penalties — I understand part of its reason for disliking my reading of the code.

First, under my interpretation, the IRS is prevented from assessing a 75 percent civil fraud penalty under section 6663 on people who flagrantly obtain EITC refunds improperly — although my reading of the code does not prohibit criminal prosecution of those people.

Second, the IRS doesn't want to have its auditors send out both a notice of deficiency to recover the improper refund resulting from the refundable credit and another notice (a notice and demand) after immediately assessing a 20 percent section 6676 penalty on any improper refundable credit other than the EITC. That dual route not only would create more paperwork for the IRS but also would likely generate multiple court cases if a taxpayer later challenged the IRS's position that the credit was improper. There would be a deficiency proceeding in the Tax Court under section 6213(a) in which the IRS sought return of the credit and perhaps a section 6662 penalty on the amount of the credit used to bring the tax down to $0. There would also be either a prepayment CDP appeal in the Tax Court under section 6330(d) after the taxpayer challenged his underlying liability for the section 6676 penalty (as to which no notice of deficiency had been issued) or a post-payment refund suit in district court or the Court of Federal Claims to recover the amount paid for the section 6676 penalty.

All this procedure would make anyone's head spin. But the problem is that Congress seems to have provided for exactly this system in 2007 — perhaps unwittingly.

Rather than simply continuing to assert only section 6662 penalties, which it clearly prefers over the section 6676 penalty, the IRS should be going to Capitol Hill for a clarification of the interplay of the two penalties to reduce any duplication or unintended consequences. Indeed, I would support that action. Neither penalty is well thought through as it applies to refundable credit disallowances.

As I see it, if a refundable credit is to be recovered by the IRS through the deficiency procedures (Congress's 1988 decision), section 6664(a)'s definition of underpayment should be formally modified so that a section 6662 or section 6663 penalty can be asserted on the entire disallowed credit in the same notice of deficiency. If Congress still wants to exempt EITC refunds from a 20 percent penalty, it can do so by amending section 6664(a). If Congress also wants to make it easier for the IRS to impose a 20 percent penalty when a taxpayer has improperly claimed a tax refund (that is, eliminate the need for the IRS to prove negligence of substantial understatement), Congress can also easily modify section 6662 to add a new subsection for this specific bad conduct of obtaining an excessive refund, using language similar to that currently found in section 6676(a).

If, however, a tax refund from a credit is recovered not through the deficiency procedures (as would happen, say, if a person overstated withholding credits under section 31 or 33), there should be no section 6662 or 6663 penalties on that behavior. Instead, section 6676 should be amended to provide a penalty of 20 percent (75 percent in the case of fraud) on the improper refund that is similarly not asserted through the deficiency procedures, so credit and penalty disputes could be joined in a single court action. The IRS could help by removing the regulatory provision that includes overstatements of payments and withholding credits in the section 6664(a) definition of underpayment. In chief counsel advice, the IRS has concluded that section 6676's penalty cannot apply to overstated withholding credits because they are now part of the underpayment under section 6664 to which the section 6662 penalty applies.[22] Thus, for overstated withholding credits, the IRS now follows the deficiency procedures to obtain a 20 percent penalty, but it follows other, non-deficiency procedures to adjust the actual overstatement. This makes little policy sense.

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[22]ILM 201018002, *Doc 2010-10193, 2010 TNT 89-40.*

Conclusion

The Tax Court's opinion in *Rand* will not end the controversy over how the section 6662 penalty applies to disallowed refundable tax credits. No matter which party loses, *Rand* will surely be appealed to the Seventh Circuit.

And other Tax Court cases involving the refundable credit penalty issue will be appealable to different circuits. Indeed, I recently entered pro bono appearances in consolidated pro se cases to ask the Tax Court to reconsider its determination that the taxpayers were liable for section 6662 penalties on disallowed section 36 first-time home buyer credits (which it apparently did without realizing that the cases presented the ''underpayment'' issue).[23] That reconsideration might allow the cases to be litigating vehicles for appeal of the penalty issue to the Ninth Circuit. Clinicians in other circuits have told me that they have the same issue presented in their clinics and are considering raising objection to section 6662 penalties on refundable credit disallowances.

The IRS should not engage in a prolonged battle with tax clinic and pro bono counsel in the circuits. Rather, Treasury's assistant secretary for tax policy should approach the relevant taxwriting committees about a sensible legislative fix to which the IRS, taxpayer representatives, and members of Congress could, prospectively, all agree.

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[23]*Morales v. Commissioner*, T.C. Memo. 2012-341, *Doc 2012-25122, 2012 TNT 236-16*.