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corporation. In such a case, the Service shall notify the corporation of the credit, and refund the balance of the adjustment.

(f) *Effect of adjustment.* (1) For purposes of all sections of the Internal Revenue Code except section 6655, relating to additions to tax for failure to pay estimated income tax, any adjustment under section 6425 is to be treated as a reduction of prior estimated tax payments as of the date the credit is allowed or the refund is paid. For the purpose of sections 6655(a) through (g), (i), and (j), credit or refund of an adjustment is to be treated as if not made in determining whether there has been any underpayment of estimated income tax and, if there is an underpayment, the period during which the underpayment existed. However, an excessive adjustment under section 6425 is taken into account in applying the addition to tax under section 6655(h).

(2) For the effect of an excessive adjustment under section 6425, see §1.6655–7.

(3) *Effective/applicability date:* This paragraph (f) is applicable to applications for adjustments of overpayments of estimated income tax that are filed in taxable years beginning after September 6, 2007.

[T.D. 7059, 35 FR 14547, Sept. 17, 1970 as amended by T.D. 9347, 72 FR 44348, Aug. 7, 2007]

ADDITIONS TO THE TAX, ADDITIONAL AMOUNTS, AND ASSESSABLE PENALTIES

§ 1.6654–1 Addition to the tax in the case of an individual.

(a) *In general.* (1) Section 6654 imposes an addition to the taxes under chapters 1 and 2 of the Code in the case of any underpayment of estimated tax by an individual (with certain exceptions described in section 6654(d)), including any underpayment of estimated qualified State individual income taxes which are treated pursuant to section 6361(a) as if they were imposed by chapter 1. This addition to the tax is in addition to any applicable criminal penalties and is imposed whether or not there was reasonable cause for the underpayment. The amount of the underpayment for any installment date is the excess of:

(i) The following percentages of the tax shown on the return for the taxable year or, if no return was filed, of the tax for such year, divided by the number of installment dates prescribed for such taxable year:

(A) 80 percent in the case of taxable years beginning after December 31, 1966, of individuals not referred to in section 6073(b) (relating to income from farming or fishing);

(B) 70 percent in the case of taxable years beginning before January 1, 1967, of such individuals; and

(C) 66⅔ percent in the case of individuals referred to in section 6073(b); over

(ii) The amount, if any, of the installment paid on or before the last day prescribed for such payment.

(2) The amount of the addition is determinated at the annual rate referred to in the regulations under section 6621 upon the underpayment of any installment of estimated tax for the period from the date such installment is required to be paid until the 15th day of the fourth month following the close of the taxable year, or the date such underpayment is paid, whichever is earlier. For purposes of determining the period of the underpayment (i) the date prescribed for the payment of any installment of estimated tax shall be determined without regard to any extension of time, and (ii) a payment of estimated tax on any installment date, to the extent that it exceeds the amount of the installment determined under subparagraph (1)(i) of this paragraph for such installment date, shall be considered a payment of any previous underpayment.

(3) In determining the amount of the installment paid on or before the last day prescribed for payment thereof, the estimated tax shall be computed without any reduction for the amount which the taxpayer estimates as his credit under section 31 (relating to tax withheld at source on wages), and the amount of such credit shall be deemed a payment of estimated tax. An equal part of the amount of such credit shall be deemed paid on each installment date (determined under section 6153) for the taxable year unless the taxpayer establishes the dates on which

all amounts were actually withheld. In the latter case, all amounts withheld shall be considered as payments of estimated tax on the dates such amounts were actually withheld. Under section 31 the entire amount withheld during a calendar year is allowed as a credit against the tax for the taxable year which begins in such calendar year. However, where more than one taxable year begins in any calendar year no portion of the amount withheld during the calendar year will be treated as a payment of estimated tax for any taxable year other than the last taxable year beginning in such calendar year. The rules prescribed in this subparagraph for determining the time as of which the amount withheld shall be deemed paid are applicable even though such amount was withheld during a taxable year preceding that for which the credit is allowed.

(4) The term *tax* when used in subparagraph (1)(i) of this paragraph shall mean:

(i) The tax imposed by chapter 1 of the Code (other than by section 56 or, for taxable years ending before September 30, 1968, the tax surcharge imposed by section 51), including any qualified State individual income taxes which are treated pursuant to section 6361(a) as if they were imposed by chapter 1, plus—

(ii) For taxable years beginning after December 31, 1966, the tax imposed by chapter 2 of the Code, minus

(iii) All credits allowed by part IV, subchapter A of chapter 1, except the credit provided by section 31, relating to tax withheld at source on wages, minus

(iv) In the case of an individual who is subject to one or more qualified State individual incomes taxes, the sum of the credits allowed against such taxes pursuant to section 6362(b)(2) (B) or (C) or section 6362(c)(4) and paragraph (c) of § 301.6362–4 of this chapter (Regulations on Procedure and Administration) (relating to the credit for income taxes of other States or political subdivisions thereof) and paragraph (c)(2) of § 301.6361–1 (relating to the credit for tax withheld from wages on account of qualified State individual income taxes), and minus

(v) For taxable years ending after February 29, 1980, the individual's overpayment of windfall profit tax imposed by section 4986 of the Code for the taxable year. For this purpose, the amount of such overpayment is the sum of (A) the amount by which such individual's aggregate windfall profit tax liability for the taxable year as a producer of crude oil is exceeded by withholding of windfall profit tax for the taxable year, and (B) any amount treated under section 6429 or 6430 as an overpayment of windfall profit tax for crude oil removed during the taxable year. The deemed payment date in section 4995(a)(4)(B) for the amount of windfall profit tax withheld with respect to payments for crude oil shall have no effect in the determination of the overpayment of windfall profit tax.

(b) *Statement relating to underpayment.* If there has been an underpayment of estimated tax as of any installment date prescribed for its payment and the taxpayer believes that one or more of the exceptions described in § 1.6654–2 precludes the assertion of the addition to the tax under section 6654, he should attach to his income tax return for the taxable year a Form 2210 showing the applicability of any exception upon which he relies.

(c) *Examples.* The method prescribed in paragraph (a) of this section for computing the addition to the tax may be illustrated by the following examples:

Example 1. An individual taxpayer files his return for the calendar year 1972 on April 15, 1973, showing a tax (income and self-employment tax) of $30,000. He had paid a total of $20,000 of estimated tax in four installments of $5,000 on each of the four installment dates prescribed for such year. No other payments were made prior to the date the return was filed. Since the amount of each installment paid by the last date prescribed for payment thereof is less than one-quarter of 80 percent of the tax shown on the return, the addition to the tax is applicable in respect of the underpayment existing as of each installment date and is computed as follows:

(1) Amount of tax shown on return	$30,000
(2) 80 percent of item (1)	24,000
(3) One-fourth of item (2)	6,000
(4) Deduct amount paid on each installment date	5,000

(5) Amount of underpayment for each installment date (item (3) minus item (4))	1,000
(6) Addition to the tax:	
1st installment—period 4–15–72 to 4–15–73	60
2nd installment—period 6–15–72 to 4–15–73	50
3rd installment—period 9–15–72 to 4–15–73	35
4th installment—period 1–15–73 to 4–15–73	15
Total	$160

Example 2. An individual taxpayer files his return for the calendar year 1955 on April 15, 1956, showing a tax of $30,000. The requirements of section 6015(a) were first met after April 1 and before June 2, 1955, and a total of $18,000 of estimated tax was paid in three equal installments of $6,000 on each of the three installment dates prescribed for such year. Since the amount of each installment paid by the last date prescribed for payment thereof is less than one-third of 70 percent of the tax shown on the return, the addition to the tax is existing as of each installment date and is applicable in respect of the underpayment computed as follows:

(1) Amount of tax shown on return		$30,000
(2) 70 percent of item (1)		21,000
(3) One-third of item (2)		7,000
(4) Deduct amount paid on each installment date		6,000
(5) Amount of underpayment for each installment date (item (3) minus item (4))		1,000
(6) Addition to the tax:		
1st installment—period 6–15–55 to 4–15–56	$50	
2d installment—period 9–15–55 to 4–15–56	35	
3d installment—period 1–15–56 to 4–15–56	15	
Total	100	

(Secs. 6015, 6154, 6654, 6655, and 7805, Internal Revenue Code of 1954 (96 Stat. 2395 and 2396, 68A Stat. 917; 26 U.S.C. 6015, 6154, 6654, 6655, and 7805))

[T.D. 6500, 25 FR 12146, Nov. 26, 1960, as amended by T.D. 7384, 40 FR 49322, Oct. 22, 1975; T.D. 7427, 41 FR 34029, Aug. 12, 1976; T.D. 7577, 43 FR 59358, Dec. 20, 1978; T.D. 8016, 50 FR 11855, Mar. 26, 1985]

§ 1.6654–2 Exceptions to imposition of the addition to the tax in the case of individuals.

(a) *In general.* The addition to the tax under section 6654 will not be imposed for any underpayment of any installment of estimated tax if, on or before the date prescribed for payment of the installment, the total amount of all payments of estimated tax made equals or exceeds the lesser of the amount in §1.6654–2(a)(1) or the amount in §1.6654–2(a)(2).

(1)(i) The amount which would have been required to be paid on or before the date prescribed for payment if the estimated tax were the tax shown on the return for the preceding taxable year, provided that the preceding taxable year was a year of 12 months and a return showing a liability for tax was filed for such year. However, this subparagraph shall not apply with respect to any taxable year which ends on or after September 30, 1968, for which a tax is imposed by section 51 (relating to tax surcharge), in the case of a payment of estimated tax the time prescribed for payment of which is on or after September 15, 1968.

(ii) *Special rule for taxable years beginning in 2009.* For any taxable year beginning in 2009, for a qualified individual, the amount described in paragraph (a)(1)(i) of this section is reduced to 90 percent of that amount.

(A) *Qualified individual* means any individual whose adjusted gross income shown on the individual's return for the preceding taxable year is less than $500,000 and who certifies, as prescribed in paragraph (a)(1)(ii)(D) of this section, that more than 50 percent of the gross income shown on the return for the preceding taxable year was income from a small business.

(B) *Income from a small business* means income from the operation of a bona fide trade or business of which the individual was an owner during calendar year 2009, and that on average had fewer than 500 employees in calendar year 2008.

(C) The trade or business may be organized as, or take the legal form of, a corporation, partnership, limited liability company, or sole proprietorship.

(D) A qualified individual shall file a certification of the individual's qualification in the manner and at the time prescribed by the Internal Revenue Service in forms, publications, or other guidance.

(2) The amount which would have been required to be paid on or before the date prescribed for payment if the estimated tax were an amount equal to a percentage of the tax computed by placing on an annual basis the taxable

income for the calendar months in the taxable year ending before the month in which the installment is required to be paid. That percentage is 80 percent in the case of taxable years beginning after December 31, 1966, of individuals not referred to in section 6073(b) (relating to income from farming or fishing), 70 percent in the case of taxable years beginning before January 1, 1967, of such individuals, and 66⅔ percent in the case of individuals referred to inferred to in section 6073(b). With respect to taxable years beginning after December 31, 1966, the adjusted self-employment income shall be taken into account in determining the amount referred to in this subparagraph if net earnings from self-employment (as defined in section 1402(a)) for the taxable year equal or exceed $400. For purposes of this subparagraph:

(i) Taxable income shall be placed on an annualized basis:

(A) For taxable years beginning after 1976, by:

(*1*) Multiplying by 12 (or the number of months in the taxable year if less than 12) the adjusted gross income and the itemized deductions for the calendar months in the taxable year ending before the month in which the installment is required to be paid,

(*2*) Dividing the resulting amounts by the number of such calendar months,

(*3*) Increasing the amount of the annualized adjusted gross income by the unused zero bracket amount, if any, determined by reference to the annualized itemized deductions, or decreasing the amount of the annualized adjusted gross income by the excess itemized deductions, if any, determined by reference to the annualized itemized deductions (the amount resulting under this step is annualized tax table income), and

(*4*) Deducting from the annualized tax table income the deduction for personal exemptions (such personal exemptions being determined as of the date prescribed for payment of the installment).

If the taxpayer would be eligible to use the tax tables on the basis of annualized tax table income, the amount which would have been required to be paid for purposes of this subparagraph may be determined by applying the tax tables to annualized tax table income. the amount resulting under (3).

(B) For taxable years beginning before 1977, by:

(*1*) Multiplying by 12 (or the number of months in the taxable year if less than 12) the taxable income (computed without the standard deduction and without the deduction for personal exemptions), or the adjusted gross income if the standard deduction is to be used for the calendar months in the taxable year ending before the month in which the installment is required to be paid,

(*2*) Dividing the resulting amount by the number of such calendar months, and

(*3*) Deducting from such amount the standard deduction, if applicable, and the deduction for personal exemptions (such personal exemptions being determined as of the date prescribed for payment of the installment).

(ii) The term ''adjusted self-employment income'' means:

(A) The net earnings from self-employment (as defined in section 1402(a)) for the calendar months in the taxable year ending before the month in which the installment is required to be paid, computed as if such months constituted the taxable year, but not more than

(B) The excess of:

(*1*) For taxable years beginning after 1966, $6,600

(*2*) For taxable years beginning after 1971, $9,000,

(*3*) For taxable years beginning after 1972, $10,800,

(*4*) For taxable years beginning after 1973, $13,200, and

(*5*) For taxable years beginning after 1974, an amount equal to the contribution and benefit base (as determined under section 230 of the Social Security Act) which is effective for the calendar year in which the taxable year begins, over the amount of the wages (within the meaning of section 1402(b)) for such calendar months placed on an annual basis. For this purpose, wages are annualized by multiplying by 12 (or the number of months in the taxable year in the case of a taxable year of less than 12 months) the wages for such calendar months and dividing the resulting amount by the number of such months.

(3) An amount equal to 90 percent of the tax computed, at the rates applicable to the taxable year, on the basis of the actual taxable income for the calendar months in the taxable year ending before the month in which the installment is required to be paid, as if such months constituted the entire taxable year. For taxable years beginning after December 31, 1966, such computation shall include the tax imposed by chapter 2 on the actual self-employment income for such months. For purposes of this subparagraph, the term ''actual self-employment income'' means:

(i) The net earnings from self-employment (as defined in section 1402(a))for such calendar months, computed as if such months constituted the taxable year, but not more than

(ii) The excess of:

(A) For taxable years beginning after 1966, $6,600,

(B) For taxable years beginning after 1971, $9,000,

(C) For taxable years beginning after 1972, $10,800,

(D) For taxable years beginning after 1973, $13,200, and

(E) For taxable years beginning after 1974, an amount equal to the contribution and benefit base (as determined under section 230 of the Social Security Act) which is effective for the calendar year in which the taxable year begins, over the amount of wages (within the meaning of section 1402(b)) for such months.

(4) The amount which would have been required to be paid on or before the date prescribed for payment if the estimated tax were an amount equal to a tax determined on the basis of the tax rates and the taxpayer's status with respect to personal exemptions under section 151 for the taxable year, but otherwise on the basis of the facts shown on the return for the preceding taxable year and the law applicable to such year, in the case of an individual required to file a return for such preceding taxable year.

In the case of a taxpayer whose taxable year consists of 52 or 53 weeks in accordance with section 441(f), the rules prescribed by §1.441–2(c) shall be applicable in determining, for purposes of subparagraph (1) of this paragraph, whether a taxable year was a year of 12 months and, for purposes of subparagraphs (2) and (3) of this paragraph, the number of calendar months in a taxable year preceding the date prescribed for payment of an installment of estimated tax. For the rules to be applied in determining taxable income for any period described in subparagraphs (2) and (3) of this paragraph in the case of a taxpayer who employs accounting periods (e.g., thirteen 4-week periods or four 13-week periods) none of which terminates with the end of the applicable period described in subparagraph (2) or (3) of this paragraph, see paragraph (a)(5) of §1.6655–2.

(b) *Meaning of terms.* As used in this section and §1.6654–3:

(1) The term ''tax'' means:

(i) The tax imposed by chapter 1 of the Code (other than by section 56), including any qualified State individual income taxes which are treated pursuant to section 6361(a) as if they were imposed by chapter 1, plus

(ii) For taxable years beginning after December 31, 1966, the tax imposed by chapter 2 of the Code, minus

(iii) The credits against tax allowed by part iv, subchapter A, chapter 1 of the Code, other than the credit against tax provided by section 31 (relating to tax withheld on wages), and without reduction for any payments of estimated tax, minus

(iv) In the case of an individual who is subject to one or more qualified State individual income taxes, the sum of the credits allowed against such taxes pursuant to section 6262(b)(2) (B) or (C) or section 6262(c)(4) and paragraph (c) of §301.6362–4 of this chapter (Regulations on Procedure and Administration) (relating to the credit for income taxes of other States or political subdivisions thereof) and paragraph (c)(2) of §301.6361–1 (relating to the credit for tax withheld from wages on account of qualified State individual income taxes), and minus

(v) For taxable years ending after February 29, 1980, the individual's overpayment of windfall profit tax imposed by section 4986 of the Code for the taxable year. For this purpose, the amount of such overpayment is the sum of (A) the amount by which such individual's aggregate windfall profit tax liability for the taxable year as producer of crude oil is exceeded by withholding of windfall profit tax for the taxable year, and (B) any amount treated under section 6429 or 6430 as an overpayment of windfall profit tax for crude oil removed during the taxable year. The deemed payment date in section 4995(a)(4)(B) for the amount of windfall profit tax withheld with respect to payments for crude oil shall have no effect in the determination of the overpayment of windfall profit tax.

(2) The credits against tax allowed by part IV, subchapter A, chapter 1 of the Code, are:

(i) In the case of the exception described in paragraph (a)(1) of this section, the credits shown on the return for the preceding taxable year,

(ii) In the case of the exceptions described in paragraph (a)(2) and (3) of this section, the credits computed under the law and rates applicable to the current taxable year, and

(iii) In the case of the exception described in paragraph (a)(4) of this section, the credits shown on the return for the preceding taxable year, except that if the amount of any such credit would be affected by any change in rates or status with respect to personal exemptions, the credits shall be determined by reference to the rates and status applicable to the current taxable year.

A change in rate may be either a change in the rate of tax, such as a change in the rate of the tax imposed by section 1 or section 1401, or a change in a percentage affecting the computation of the credit, such as a change in the rate of withholding under chapter 3 of the Code or a change in the percentage of a qualified investment which is specified in section 46 for use in determining the amount of the investment credit allowed by section 38.

(3) The term "return for the preceding taxable year" means the income tax return for such year which is required by section 6012(a)(1) and, in the case of taxable years beginning after December 31, 1966, the self-employment tax return for such year which is required by section 607.

(c) *Examples.* The following examples illustrate the application of the exceptions to the imposition of the addition to the tax for an underpayment of estimated tax, in the case of an individual whose taxable year is the calendar year:

Example 1. A, a married man with one child and a dependent parent, files a joint return with his spouse, B, for 1955 on April 15, 1956, showing taxable income of $44,000 and a tax of $16,760. A and B had filed a joint declaration of estimated tax on April 15, 1955, showing an estimated tax of $10,000 which was paid in four equal installments of $2,500 each on April 15, June 15, and September 15, 1955, and January 15, 1956. The balance of $6,760 was paid with the return. A and B have an underpayment of estimated tax of $433 (1/4 of 70 percent of $16,760, less $2,500) for each installment date. The 1954 calendar year return of A and B showed a liability of $10,000. Since the total amount of estimated tax paid by each installment date equalled the amount that would have been required to be paid on or before each of such dates if the estimated tax were the tax shown on the return for the preceding year, the exception described in paragraph (a)(1) of this section applies and no addition to the tax will be imposed.

Example 2. Assume the same facts as in example (1), except that the joint return of A and B for 1954 showed taxable income of $32,000 and a tax liability of $10,400. Assume further that only two personal exemptions under section 151 appeared on the 1954 return. The exception described in paragraph (a)(1) of this section would not apply. However, A and B are entitled to four exemptions under section 151 for 1955. Taxable income for 1954 based on four exemptions, but otherwise on the basis of the facts shown on the 1954 return, would be $30,800. The tax on such amount in the case of a joint return would be $9,836. Since the total amount of estimated tax paid by each installment date exceeds the amount which would have been required to be paid on or before each of such dates if the estimated tax were $9,836, the exception described in paragraph (a)(4) of this section applies and no addition to the tax will be imposed.

Example 3. C, who is self-employed (other than as a farmer or fisherman), has annualized taxable income of $6,900 for the period January 1, 1967, through August 31, 1967, the income tax on which is $1,171. For the same period his net earnings from self-employment are $5,000 and his wages are $2,000. The estimated tax payments made by C for 1967 on or before September 15, 1967, total $1,200. For the purposes of the exception described in paragraph (a)(2) of this section, the adjusted self-employment income is $3,600, computed as follows:

(1) Net earnings from self-employment	$5,000
(2) $6,600 minus annualized wages ($6,600 − 3,000 ($2,000×12÷8))	3,600
(3) Lesser of (1) or (2)	3,600

The tax on C's adjusted self-employment income would be $230.40 ($3,600×6.4 percent). Since the total amount of estimated tax paid on or before September 15, 1967, exceeds $1,121.12, that is, 80 percent of $1,401.40 ($1,171+230.40), the exception described in paragraph (a)(2) of this section applies and no addition to tax will be imposed.

Example 4. D, who is self-employed (other than as a farmer or fisherman), has actual taxable income of $3,800 for the period January 1, 1967, through August 31, 1967, the income tax on which is $586. For the same period his net earnings from self-employment are $5,000 and his wages are $2,000. The estimated tax payments made by D for 1967 on or before September 15, 1967, total $840. For the purposes of the exception described in paragraph (a)(3) of this section, the actual self-employment income for this period is $4,600, computed as follows:

(1) Net earnings from self-employment	$5,000
(2) $6,600 minus wages ($6,600 − 2,000)	4,600
(3) Lesser of (1) or (2)	4,600

The tax on D's actual self-employment income would be $294.40 ($4,600×6.4 percent). Since the total amount of estimated tax paid by September 15, 1967, exceeds $792.36, that is, 90 percent of $880.40 ($586+294.40), the exception described in paragraph (a)(3) of this section applies and no addition to tax will be imposed.

Example 5. E and F, his spouse, filed a joint return for the calendar year 1967, showing a tax liability of $10,000. The liability, attributable primarily to income received during the last quarter of the year, included both income and self-employment tax. Their aggregate payments of estimated tax on or before September 15, 1967, total $1,350, representing three installments of $450 paid on each of the first three installment dates prescribed for the taxable year. Since each installment paid, $450, was less then $2,000 (¼ of 80 percent of $10,000), there was an underpayment on each of the installment dates. Assume that the exceptions described in paragraph (a) (1) and (4) of this section do not apply. Actual taxable income for the three months ending March 31, 1967, was $2,000 and for the five months ending May 31, 1967, was $4,500. Actual self-employment income, for the same periods, was $2,000 and $4,000, respectively. Since the amounts paid by the April 15 and June 15 installment dates, $450 and $900, respectively, exceed $376.20 and $873.90, respectively (90 percent of the income tax on the actual taxable income of $2,000 and $4,500, respectively, determined on the basis of a joint return, and the self-employment tax on the actual self-employment income of $2,000 and $4,000, respectively), the exception described in paragraph (a)(3) of this section applies and no addition to the tax will be imposed for the underpayments on the April 15 and June 15 installment dates. For the eight months ending August 31, 1967, actual taxable income, assuming E and F did not elect to use the standard deduction, was $7,500; net earnings from self-employment were $6,000 and wages were $2,700. Since the total amount paid by the September 15 installment date, $1,350, was less than $1,381.14 (90 percent of the income tax on the actual taxable income of $7,500 determined on the basis of a joint return and the self-employment tax on actual self-employment income of $3,900 ($6,600 − 2,700)), the exception described in paragraph (a)(3) of this section does not apply to the September 15 installment. Furthermore, the exception described in paragraph (a)(2) of this section does not apply, as illustrated by the following computation:

(1) Income tax:	
Taxable income for the period ending Aug. 31, 1967 (without deduction for personal exemptions) on an annual basis ($8,700×12÷8)	$13,050.00
Deduction for two personal exemptions	1,200.00
	11,850.00
Tax on $11,850 (on the basis of a joint return)	2,227.00
(2) Self-employment tax:	
Net earnings from self-employment	6,000.00
Adjusted self-employment income ($6,600 − 4,050 annualized wages ($2,700×12÷8))	2,550.00
Tax on adjusted self-employment income ($2,550×6.4 percent)	163.20
(3) Total tax ($2,227.00+163.20)	2,390.20
(4) ¾ of 80 percent of $2,390.20	1,434.12
Amount paid by Sept. 15, 1967	1,350.00

An addition to the tax will thus be imposed for the underpayment of $1,550 ($2,000 − 450) on the September 15 installment.

Example 6. Assume the same facts as in example (5) and assume further that adjusted gross income for the eight months ending August 31, 1967, was $9,200 and the amount of deductions (other than the deduction for personal exemptions) not allowable in determining adjusted gross income aggregate only $500. If E and F elect, they may use the standard deduction in computing the tax for purposes of the exceptions described in paragraph (a) (2) and (3) of this section. Taxable income for purposes of the exception described in paragraph (a)(3) of this section would be reduced to $7,080 ($9,200 less $1,200 for two personal exemptions and $920 for the standard deduction). The income tax thereon is $1,205.20; income tax and self-employment tax total $454.80 ($1,205.20+249.60 ($3,900×6.4

percent)). Since the amount paid by the September 15 installment date, $1,350, exceeds $1,309.32 (90 percent of $1,454.80), the exception described in paragraph (a)(3) of this section applies. However, the exception described in paragraph (a)(2) of this section does not apply, as illustrated by the following computation:

Adjusted gross income for period ending Aug. 31, 1967	$9,200.00
Adjusted gross income annualized ($9,200×12÷8)	13,800.00
Taxable income annualized ($13,800 minus $1,200 for two personal exemptions and $1,000 for the standard deduction)	11,600.00
Tax on $11,600 (on basis of joint return)	2,172.00
Self-employment tax on adjusted self-employment income ($2,550×6.4 percent)	163.20
Total tax ($2,172.00+163.20	2,335.20
¾ of 80 percent of $2,335.20	1,401.12
Amount paid by Sept. 15, 1967	1,350.00

Example 7. G was a married individual, 73 years of age, who filed a joint return with his wife, H, for the calendar year 1956. H, who was 70 years of age, had no income during the year. G had taxable income in the amount of $7,000 for the eight-month period ending on August 31, 1956, which included $2,000 of dividend income (after excluding $50 under section 116) and $900 of rental income. The $7,000 figure also reflected a deduction of $2,400 for personal exemptions ($600×4), since G and H are both over 65 years of age. The application of the exception described in paragraph (a)(2) of this section to an underpayment of estimated tax on the September 15 installment date may be illustrated by the following computation:

Taxable income for the period ending Aug. 31, 1956 (without deduction for personal exemptions) on an annual basis ($9,400×12÷8)	$14,100.00
Deduction for personal exemptions	2,400.00
Taxable income on an annual basis	11,700.00
Tax (on the basis of a joint return)	2,642.00
Dividends received for 8-month period	2,050.00
Less: Amount excluded from gross income under section 116	50.00
Dividends included in gross income	2,000.00
Dividend income annualized ($2,000×12÷8)	3,000.00
Dividends received credit under section 34 (4 percent of $3,000)	120.00
Tax less dividends received credit	2,522.00
Retirement income (as defined in section 37(c)) includes:	
Dividend income (to extent included in gross income)	2,000.00
Rental income	900.00
Total retirement income	2,900.00
Limit on amount of retirement income under section 37(d)	1,200.00
Retirement income credit under section 37 (20 percent of $1,200)	240.00
Tax less credits under section 34 and section 37	2,282.00
Amount determined under the exception described in paragraph (a)(2) of this section (¾ of 70 percent of $2,282)	1,198.05

Example 8. C, an unmarried individual for whom another taxpayer is entitled to a deduction under section 151(e), has adjusted gross income of $4,000 for the period January 1, 1977, through August 31, 1977. All of C's income is non-exempt interest. For the same period C, who is entitled to one personal exemption, has itemized deductions amounting to $300. C is entitled to no credits other than the general tax credit. C filed a declaration of estimated tax on April 15, 1977, and on or before September 15, 1977, makes estimated tax payments for 1977 which total $460. For purposes of determining whether the exception described in paragraph (a)(2) of this section applies, the following computations are necessary:

Adjusted gross income for the period ending Aug. 31, 1977, on an annual basis ($4,000 × 12÷8)		$6,000.00
Itemized deductions for the period ending Aug. 31, 1977, on an annual basis ($300 × 12÷8)		450.00
Unused zero bracket amount computation required under sec. 63(e)(1)(D):		
Zero bracket amount	$2,200.00	
Annualized itemized deductions	450.00	
Unused zero bracket amount	1,750.00	
Annualized adjusted gross income		6,000.00
Plus: unused zero bracket amount		1,750.00
Annualized tax table income		7,750.00
Tax from tables		757.00
Amount specified in paragraph (a)(2) of this section (¾×80 pct.×$757)		$454.20

The exception described in paragraph (a)(2) applies, and no addition to tax will be imposed.

Example 9. An unmarried taxpayer entitled to one exemption, has adjusted gross income of $16,000 and itemized deductions of $2,000 for the period January 1, 1977, through August 31, 1977. D has no net earnings from self-employment and is entitled to no credits other than the general tax credit. D files a declaration of estimated tax on April 15, 1977, and on or before September 15, 1977, makes estimated tax payments for 1977 which total $3,000. For purposes of determining whether the exception in paragraph (a)(2) of this section applies, the following computations are necessary:

Adjusted gross income for the period ending Aug. 31, 1977, on an annual basis ($16,000 × 12÷8)		$24,000
Itemized deductions for the period ending Aug. 31, 1977, on an annual basis ($2,000 × 12÷8)		3,000
Annualized itemized deductions	$3,000	
Minus zero bracket amount	2,200	
Excess itemized deductions	800	
Annualized adjusted gross income		24,000

Minus excess itemized deductions	800
Annualized tax table income	23,200
Minus: Personal exemption	750
Annualized taxable income	22,450
Tax under sec. 1(c) on annualized taxable income	5,325
Minus: general tax credit	180
Total	5,145
Amount specified in paragraph (a)(2) of this section (3/4×80 pct.×$5,145)	3,087

The exception described in paragraph (a)(2) does not apply.

(d) *Determination of taxable income for installment periods*—(1) *In general.* (i) In determining the applicability of the exceptions described in paragraph (a) (2) and (3) of this section, there must be an accurate determination of the amount of income and deductions for the calendar months in the taxable year preceding the installment date as of which the determination is made, that is, for the period terminating with the last day of the third, fifth, or eighth month of the taxable year. For example, a taxpayer distributes year-end bonuses to his employees but does not determine the amount of the bonuses until the last month of the taxable year. He may not deduct any portion of such year-end bonuses in determining his taxable income for any installment period other than the final installment period for the taxable year, since deductions are not allowable until paid or accrued, depending on the taxpayer's method of accounting.

(ii) If a taxpayer on an accrual method of accounting wishes to use either of the exceptions described in paragraphs (a) (2) and (3) of this section, he must establish the amount of income and deductions for each applicable period. If his income is derived from a business in which the production, purchase, or sale of merchandise is an income-producing factor requiring the use of inventories, he will be unable to determine accurately the amount of his taxable income for the applicable period unless he can establish, with reasonable accuracy, his cost of goods sold for the applicable installment period. The cost of goods sold for such period shall be considered, unless a more exact determination is available, as such part of the cost of goods sold during the entire taxable year as the gross receipts from sales for such installment period is of gross receipts from sales for the entire taxable year.

(2) *Members of partnerships.* The provisions of this subparagraph shall apply in determining the applicability of the exceptions described in paragraphs (a) (2) and (3) of this section to an underpayment of estimated tax by a taxpayer who is a member of a partnership.

(i) For purposes of determining taxable income, there shall be taken into account:

(A) The partner's distributive share of partnership items set forth under section 702,

(B) The amount of any guaranteed payments under section 707(c), and

(C) Gains or losses on partnership distributions which are treated as gains or losses on sales of property.

(ii) For purposes of determining net earnings from self-employment (for taxable years beginning after December 31, 1966) there shall be taken into account:

(A) The partner's distributive share of income or loss, described in section 702(a)(9), subject to the special rules set forth in section 1402(a) and §§1.1402(a)–1 to 1.1402(a)–16, inclusive, and

(B) The amount of any guaranteed payments under section 707(c), except for payments received from a partnership not engaged in a trade or business within the meaning of section 1402(c) and §1.1402(c)–1.

In determining a partner's taxable income and, for taxable years beginning after December 31, 1966, net earnings from self-employment, for the months in his taxable year which precede the month in which the installment date falls, the partner shall take into account items set forth in sections 702 and 1402(a) for any partnership taxable year ending with or within his taxable year to the extent that such items are attributable to months in such partnership taxable year which precede the month in which the installment date falls. For special rules used in computing a partner's net earnings from self-employment in the case of the termination of his taxable year as a result of death, see section 1402(f) and §1.1402(f)–1. In addition, a partner shall include in his taxable income and, for taxable years beginning after December 31, 1966, net earnings from self-employment, for the months in his taxable year which precede the month in which the installment date falls guaranteed payments from the partnership to the extent that such guaranteed payments are includible in his taxable income for such months. See section 706(a), section 707(c), paragraph (c) of § 1.707–1 and section 1402(a).

(iii) The provisions of subdivision (i) (A) and (B) of this subdivision (ii) of this subparagraph may be illustrated by the following examples:

Example 1. A, whose taxable year is the calendar year, is a member of a partnership whose taxable year ends on January 31. A must take into account, in determining his taxable income for the installment due on April 15, 1973, all of his distributive share of partnership items described in section 702 and the amount of any guaranteed payments made to him which were deductible by the partnership in the partnership taxable year beginning on February 1, 1972, and ending on January 31, 1973. A must take into account, in determining his net earnings from self-employment, his distributive share of partnership income or loss described in section 702(a)(9), subject to the special rules set forth in section 1402(a) and §§ 1.1402(a)–1 to 1.1402(a)–16, inclusive.

Example 2. Assume that the taxable year of the partnership of which A, a calendar year taxpayer, is a member ends on June 30. A must take into account in the determination of his taxable income and net earnings from self-employment for the installment due on April 15, 1973, his distributive share of partnership items for the period July 1, 1972, through March 31, 1973; for the installment due on June 15, 1973, he must take into account such amounts for the period July 1, 1972, through May 31, 1973; and for the installment due on September 15, 1973, he must take into account such amounts for the entire partnership taxable year of July 1, 1972, through June 30, 1973 (the date on which the partnership taxable year ends).

(3) *Beneficiaries of estates and trusts.* In determining the applicability of the exceptions described in paragraph (a) (2) and (3) of this section as of any installment date, the beneficiary of an estate or trust must take into account his distributable share of income from the estate or trust for the applicable period (whether or not actually distributed) if the trust or estate is required to distribute income to him currently. If the estate or trust is not required to distribute income currently, only the amounts actually distributed to the beneficiary during such period must be taken into account. If the taxable year of the beneficiary and the taxable year of the estate or trust are different, there shall be taken into account the beneficiary's distributable share of income, or the amount actually distributed to him as the case may be, during the months in the taxable year of the estate or trust ending within the taxable year of the beneficiary which precede the month in which the installment date falls. See subparagraph (2) of this paragraph for examples of a similar rule which is applied when a partner and the partnership of which he is a member have different taxable years.

(e) *Special rule in case of change from joint return or separate return for the preceding taxable year*—(1) *Joint return to separate returns.* In determining the applicability of the exceptions described in paragraph (a) (1) and (4) of this section to an underpayment of estimated tax, a taxpayer filing a separate return who filed a joint return for the preceding taxable year shall be subject to the following rule: The tax:

(i) Shown on the return for the preceding taxable year, or

(ii) Based on the tax rates and personal exemptions for the current taxable year but otherwise determined on the basis of the facts shown on the return for the preceding taxable year, and the law applicable to such year,

shall be that portion of the tax which bears the same ratio to the whole of the tax as the amount of the tax for which the taxpayer would have been liable bears to the sum of the taxes for which the taxpayer and his spouse would have been liable had each spouse filed a separate return for the preceding taxable year. For rules with respect to the allocation of joint payments of estimated tax, see § 1.6654–2(e)(5).

(2) *Examples.* The rule in paragraph (i) of this paragraph may be illustrated by the following examples:

Example 1. H and W filed a joint return for the calendar year 1955 showing taxable income of $20,000 and a tax of $5,280. Of the $20,000 taxable income, $18,000 was attributable to H, and $2,000 was attributable to W. H and W filed separate returns for 1956. The tax shown on the return for the preceding taxable year, for purposes of determining the applicability of the exception described in paragraph (a)(1) of this section to an underpayment of estimated tax by H for 1956, is determined as follows:

Taxable income of H for 1955	$18,000
Tax on $18,000 (on basis of separate return)	6,200
Taxable income of W for 1955	2,000
Tax on $2,000 (on basis of separate return)	400
Aggregate tax of H and W (on basis of separate returns)	6,600
Portion of 1955 tax shown on joint return attributable to H (6200/6600×5280)	4,960

Example 2. Assume the same facts as in example (1) and that H and W file a joint declaration of estimated tax for 1956 and pay estimated tax in amounts determined on the basis of their eligibility for three rather than two exemptions for 1956. H and W ultimately file separate income tax returns for 1956. Assume further that the exception described in paragraph (a)(1) of this section does not apply. The tax based on the tax rates and personal exemptions for 1956 but otherwise determined on the basis of the facts shown on the return for 1955 and the law applicable to 1955, for purposes of determining the applicability of the exception described in paragraph (a)(4) of this section to an underpayment of estimated tax by H for 1956, is determined as follows:

Taxable income of H and W for 1955 based on additional personal exemption for 1956	$19,400
Tax on 1955 income based on joint return rate for 1956	5,076
Portion of 1955 tax attributable to H (computed as in example (1) but allowing benefit of additional exemption to H)	5900/6300
Portion of tax attributable to H based on tax rates and personal exemptions for 1956 but otherwise on facts on 1955 return ($5900/6300×$5,076)	$4,754

Example 3. Assume that H and W had the same taxable income in 1972 as in 1955, and that they filed a joint return for 1972 and separate returns for 1973. Assume further that H's taxable income for 1972 included net earnings from self-employment in excess of the $9,000 maximum base for the self-employment tax for 1972, and that the joint return filed by H and W for 1972 showed tax under Chapter 1 (other than section 56) and tax under Chapter 2 totaling $5,055. The tax shown on the return for 1972, for purposes of determining the applicability of the exception described in paragraph (a)(1) of this section to an underpayment of estimated tax by H for 1973, is determined as follows:

Taxable income of H for 1972	$18,000
Chapter 1 tax (other than section 56 tax) on $18,000 (on basis of separate return)	5,170
Self-employment income of H for 1972	9,000
Chapter 2 tax on $9,000	$675
Total of such taxes	$5,845
Taxable income of W for 1972	2,000
Chapter 1 tax (other than section 56 tax) on $2,000 (on basis of separate return)	310
Aggregate tax on H and W (on basis of separate returns)	$6,155
Portion of 1972 tax shown on joint return attributable to H (5845/6155×$5,055)	$4,800.40

(3) *Separate return to joint return.* In the case of a taxpayer who files a joint return for the taxable year with respect to which there is an underpayment of estimated tax and who filed a separate return for the preceding taxable year:

(i) The tax shown on the return for the preceding taxable year, for purposes of determining the applicability of the exception described in paragraph (a)(1) of this section, shall be the sum of both the tax shown on the return of the taxpayer and the tax shown on the return of the taxpayer's spouse for such preceding year, and

(ii) The facts shown on both the taxpayer's return and the return of his spouse for the preceding taxable year shall be taken into account for purposes of determining the applicability of the exception described in paragraph (a)(4) of this section.

(4) *Example.* The rules described in subparagraph (3) of this paragraph may be illustrated by the following example:

Example. H and W filed separate income tax returns for the calendar year 1954 showing tax liabilities of $2,640 and $350, respectively. In 1956 they married and participated in the filing of a joint return for that year. In the filing of a joint return for that year. Thus, for the purpose of determining the applicability of the exceptions described in paragraph (a)(1) and (4) of this section to an underpayment of estimated tax for the year 1955, the tax shown on the return for the preceding taxable year is $2,990 ($2,640 plus $350).

(Secs. 6015, 6154, 6654, 6655, and 7805, Internal Revenue Code of 1954 (96 Stat. 2395 and 2396, 68A Stat. 917; 26 U.S.C. 6015, 6154, 6654, 6655, and 7805))

(5) *Joint payments of estimated tax*—(i) *In general.* A husband and wife may make a joint payment of estimated tax even though they are not living together. However, a joint payment of estimated tax may not be made if the husband and wife are separated under a decree of divorce or of separate maintenance. A joint payment of estimated tax may not be made if the taxpayer's spouse is a nonresident alien (including a nonresident alien who is a bona fide resident of Puerto Rico or a possession

to which section 931 applies during the entire taxable year), unless an election is in effect for the taxable year under section 6013(g) or (h) and the regulations. In addition, a joint payment of estimated tax may not be made if the taxpayer's spouse has a taxable year different from that of the taxpayer. If a joint payment of estimated tax is made, the amount estimated as the income tax imposed by chapter 1 of the Internal Revenue Code must be computed on the aggregate estimated taxable income of the spouses (see section 6013(d)(3) and § 1.2–1), whereas, if applicable, the amount estimated as the self-employment tax imposed by chapter 2 of the Internal Revenue Code must be computed on the separate estimated self-employment income of each spouse. See sections 1401 and 1402 and § 1.6017–1(b)(1). The liability with respect to the estimated tax, in the case of a joint payment, shall be joint and several.

(ii) *Application to separate returns.* (A) Although a husband and wife may make a joint payment of estimated tax, they, nevertheless, can file separate returns. If they make a joint payment of estimated tax and file separate returns for the same taxable year with respect to which the joint payment was made, the payment made on account of the estimated tax for that taxable year may be treated as a payment on account of the tax liability of either the husband or wife for the taxable year, or may be divided between them in such manner as they may agree.

(B) In the event the husband and wife fail to agree to a division of the estimated tax payment, such payment shall be allocated between them in accordance with the following rule. The portion of such payment to be allocated to a taxpayer shall be that portion of the aggregate of all such payments as the amount of tax imposed by chapter 1 of the Internal Revenue Code shown on the separate return of the taxpayer (plus, if applicable, the amount of tax imposed by chapter 2 of the Internal Revenue Code shown on the return of the taxpayer) bears to the sum of the taxes imposed by chapter 1 of the Internal Revenue Code shown on the separate returns of the taxpayer and the spouse (plus, if applicable, the sum of the taxes imposed by chapter 2 of the Internal Revenue Code shown on the separate returns of the taxpayer and the spouse).

(6) *Example.* The rule described in paragraph (e)(5) of this section may be illustrated by the following example:

Example. (i) H and W make a joint payment of estimated tax of $19,500 for the taxable year. H and W subsequently file separate returns for the taxable year showing tax imposed by chapter 1 of the Internal Revenue Code in the amount of $11,500 and $8,000, respectively. In addition, H's return shows a tax imposed by chapter 2 of the Internal Revenue Code in the amount of $500. H and W fail to agree to a division of the estimated tax paid. The amount of the aggregate estimated tax payments allocated to H is determined as follows:

(A) Chapter 1 tax shown on H's return—$11,500

(B) Plus: Amount of tax imposed by chapter 2 shown on H's return—$500

(C) Total taxes imposed by chapter 1 and by chapter 2 shown on H's return—$12,000

(D) Amount of tax imposed by chapter 1 shown on W's return—$8,000

(E) Total taxes imposed by chapter 1 and by chapter 2 on both H's and W's—$20,000 returns

(F) Proportion of taxes shown on H's return to total amount—($12,000/$20,000) 60% of taxes shown on both H's and W's returns

(G) Amount of estimated tax payments allocated to H (60% of $19,500)—$11,700

(ii) Accordingly, H's return would show a balance due in the amount of $300 ($12,000 taxes shown less $11,700 estimated tax allocated).

(7) *Death of spouse.* (i) A joint payment of estimated tax may not be made after the death of either the husband or wife. However, if it is reasonable for a surviving spouse to assume that there will be filed a joint return for himself and the deceased spouse for his taxable year and the last taxable year of the deceased spouse, he may, in making a separate payment of estimated tax for his taxable year which includes the period comprising such last taxable year of his spouse, estimate the amount of the tax imposed by chapter 1 of the Internal Revenue Code on his and his spouse's taxable income on an aggregate basis and compute his estimated tax with respect to chapter 1 tax in the same manner as though a joint return had been filed.

(ii) If a husband and wife make a joint payment of estimated tax and thereafter one spouse dies, no further payments of joint estimated tax liability are required from the estate of the decedent. The surviving spouse, however, shall be liable for the payment of any subsequent installments of the joint estimated tax. For the purpose of making an amended payment of estimated tax by the surviving spouse, and the allocation of payments made pursuant to a joint payment of estimated tax between the surviving spouse and the legal representative of the decedent in the event a joint return is not filed, the payment of estimated tax may be divided between the decedent and the surviving spouse in such proportion as the surviving spouse and the legal representative of the decedent may agree.

(iii) If the surviving spouse and the legal representative of the decedent fail to agree to a division of a payment, such payment shall be allocated in accordance with the following rule. The portion of such payment to be allocated to the surviving spouse shall be that portion of the aggregate amount of such payments as the amount of tax imposed by chapter 1 of the Internal Revenue Code shown on the separate return of the surviving spouse (plus, if applicable, the amount of tax imposed by chapter 2 of the Internal Revenue Code shown on the return of the surviving spouse) bears to the sum imposed by chapter 1 of the Internal Revenue Code shown on the separate returns of the surviving spouse and of the decedent (plus, if applicable, the sum of the taxes imposed by chapter 2 of the Internal Revenue Code shown on the returns of the surviving spouse and of the decedent); and the balance of such payments shall be allocated to the decedent. This rule may be illustrated by analogizing the surviving spouse described in this rule to H in the example contained in paragraph (e)(6) of this section and the decedent in this rule to W in that example.

(f) *Effective/applicability date.* Paragraph (a)(1)(ii) of this section applies to any taxable year beginning in 2009 and does not apply to any taxable years beginning before or after 2009.

[T.D. 7427, 41 FR 34029, Aug. 12, 1976, as amended by T.D. 7577, 43 FR 59359, Dec. 20, 1978; T.D. 7585, 44 FR 1105, Jan. 4, 1979; T.D. 8016, 50 FR 11855, Mar. 26, 1985; 50 FR 18244, Apr. 30, 1985; T.D. 8996, 67 FR 35012, May 17, 2002; T.D. 9224, 70 FR 52300, Sept. 2, 2005; T.D. 9480, 75 FR 9102, Mar. 1, 2010; T.D. 9613, 78 FR 13222, Feb. 27, 2013]

§ 1.6654–3 Short taxable years of individuals.

(a) *In general.* The provisions of section 6654, with certain modifications relating to the application of section 6654(d), which are explained in paragraph (b) of this section, are applicable in the case of a short taxable year.

(b) *Rules as to application of section 6654(d).* (1) In any case in which the taxable year for which an underpayment of estimated tax exists is a short taxable year due to a change in annual accounting periods, in determining the tax:

(i) Shown on the return for the preceding taxable year (for purposes of section 6654(d)(1)), or

(ii) Based on the personal exemptions and rates for the current taxable year but otherwise on the basis of the facts shown on the return for the preceding taxable year, and the law applicable to such year (for purposes of section 6654(d)(4)),

the tax will be reduced by multiplying it by the number of months in the short taxable year and dividing the resulting amount by 12.

(2) If the taxable year for which an underpayment of estimated tax exists is a short taxable year due to a change in annual accounting periods, in annualizing the taxable income for the months in the taxable year preceding an installment date, for purposes of section 6654(d)(1)(C), the personal exemptions allowed as deductions under section 151 shall be reduced to the same extent that they are reduced under section 443(c) in computing the tax for a short taxable year.

(3) If "the preceding taxable year" referred to in section 6654(d)(4) was a short taxable year, for purposes of determining the applicability of the exception described in section 6654(d)(4), the tax, computed on the basis in the

facts shown on the return for the preceding year, shall be the tax computed on the annual basis in the manner described in section 443(b)(1) (prior to its reduction in the manner described in the last sentence thereof). If the tax rates or the taxpayer's status with respect to personal exemptions for the taxable year with respect to which the underpayment occurs differ from such rates or status applicable to the preceding taxable year, the tax determined in accordance with this subparagraph shall be recomputed to reflect the rates and status applicable to the year with respect to which the underpayment occurs.

[T.D. 6500, 25 FR 12149, Nov. 26, 1960, as amended by T.D. 7427, 41 FR 34033, Aug. 12, 1976; T.D. 9224, 70 FR 52301, Sept. 2, 2005]

§ 1.6654–4 Waiver of penalty for underpayment of 1971 estimated tax by an individual.

(a) *In general.* Section 207 of the Revenue Act of 1971 provides that, in the case of individuals, the penalty prescribed by section 6654(a) and § 1.6654–1 for underpayment of estimated tax shall not apply in certain cases to taxable years beginning after December 31, 1970, and ending before January 1, 1972. The penalty shall be waived only if the taxpayer meets one of the gross income requirements contained in paragraph (b) of this section and if the limitation contained in paragraph (c) of this section is not applicable.

(b) *Gross income requirement.* Except as provided in paragraph (c) of this section, the waiver provided in paragraph (a) of this section shall be applicable only:

(1) If the gross income for the taxable year does not exceed $10,000 in the case of:

(i) A single individual who is neither a head of a household (as defined in section 2(b)) nor a surviving spouse (as defined in section 2(a)), or

(ii) A married individual not entitled under section 6013 to file a joint return for the taxable year, or

(2) If the gross income for the taxable year does not exceed $20,000 in the case of:

(i) A head of a household (as defined in section 2(b)) or

(ii) A surviving spouse (as defined in section 2(a)), or

(3) If the aggregate gross income for the taxable year does not exceed $20,000 in the case of a married individual (entitled under section 6013 to file a joint return for the taxable year) and his spouse.

(c) *Limitation.* Notwithstanding any other provision of this section, the waiver provided in paragraph (a) of this section shall not be applicable if, in the taxable year, the taxpayer has income from sources other than wages (as defined in section 3401(a)) in excess of $200 ($400 in the case of a husband and wife entitled to file a joint return for the taxable year under section 6013). Thus, for example, even if the aggregate gross income of a husband and wife (entitled under section 6013 to file a joint return for the taxable year) does not exceed $20,000, the waiver of the penalty for underpayment of estimated tax shall not apply if the husband and wife have, in the aggregate, income from sources other than wages in excess of $400.

[T.D. 7282, 38 FR 19028, July 17, 1973]

§ 1.6654–5 Payments of estimated tax.

(a) *In general.* A payment of estimated tax by an individual shall be determined on Form 1040–ES. For the purpose of determining the estimated tax, the amount of gross income which the taxpayer can reasonably expect to receive or accrue, depending upon the method of accounting upon which taxable income is computed, and the amount of the estimated allowable deductions and credits to be taken into account in computing the amount of estimated tax, shall be determined upon the basis of the facts and circumstances existing at the time prescribed for determining the estimated tax, as well as those reasonably to be anticipated for the taxable year. If, therefore, the taxpayer is employed at the date prescribed for making an estimated tax payment at a given wage or salary, the taxpayer should presume, in the absence of circumstances indicating the contrary, for the purpose of the estimated tax payment that such employment will continue to the end of the taxable year at the wage or salary received by the taxpayer as of such date. In the case of income other than wages and salary, the regularity in the payment of income, such as dividends, interest, rents, royalties, and income arising from estates and trusts is a factor to be taken into consideration. Thus, if the taxpayer owns shares of stock in a corporation, and dividends have been paid regularly for several years upon the stock, the taxpayer should, in the absence of information indicating a change in the dividend policy, include the prospective dividends from the corporation for the taxable year as well as those actually received in such year prior to determining the estimated tax. In the case of a taxpayer engaged in business on his own account, there shall be made an estimate of gross income and deductions and credits in the light of the best available information affecting the trade, business, or profession.

(b) *Computation of estimated tax*. In computing the estimated tax the taxpayer should take into account the taxes, credits, and other amounts listed in §1.6654–1(a)(4).

[T.D. 9224, 70 FR 52301, Sept. 2, 2005]

§ 1.6654–6 Nonresident alien individuals.

(a) *In general*. A nonresident alien individual is required to make a payment of estimated tax if that individual's gross income meets the requirements of section 6654 and §1.6654–1. In making the determination under section 6654 as to whether the amount of the gross income of a nonresident alien individual is such as to require making a payment of estimated income tax, only the filing status relating to a single individual (other than a head of household) or to a married individual not entitled to file a joint return shall apply, unless an election is in effect 1 for the taxable year under section 6013(g) or (h) and the regulations.

(b) *Determination of gross income*. To determine the gross income of a nonresident alien individual who is not, or does not expect to be, a bona fide resident of Puerto Rico or a possession to which section 931 applies during the entire taxable year, see section 872 and §§1.872–1 and 1.872–2. To determine the gross income of a nonresident alien individual who is, or expects to be, a bona fide resident of Puerto Rico or a possession to which section 931 applies during the entire taxable year, see section 876 and the regulations. For rules for determining whether an individual is a bona fide resident of a United States possession (including Puerto Rico), see section 937 and the regulations.

[T.D. 9224, 70 FR 52301, Sept. 2, 2005]

§ 1.6654–7 Applicability.

Section 6654 is applicable only with respect to taxable years beginning after December 31, 1954. Section 294(d) of the Internal Revenue Code of 1939 shall continue in force with respect to taxable years beginning before January 1, 1955.

[T.D. 6500, 25 FR 12150, Nov. 26, 1960. Redesignated by T.D. 7282, 38 FR 19028, July 17, 1973. Redesignated by T.D. 9224, 70 FR 52301, Sept. 2, 2005]

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§ 1.6655–4 Large corporations.

(a) Large corporation defined.
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§ 1.6655–5 Short taxable year.

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(b) Exception to payment of estimated tax.
(c) Installment due dates.
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(i) Taxable year of at least four months but less than twelve months.
(ii) Exceptions.
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(3) Applicable percentage.
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(e) Examples.
(f) 52 or 53 week taxable year.
(g) Use of annualized income or seasonal installment method.

(1) In general.
(2) Computation of annualized income installment.
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(4) Examples.
(h) Effective/applicability date.

§ 1.6655–6 Methods of accounting.

(a) In general.
(b) Accounting method changes.
(c) Examples.
(d) Effective/applicability date.

§ 1.6655–7 Addition to tax on account of excessive adjustment under section 6425.

[T.D. 9347, 72 FR 44348, Aug. 7, 2007]

§ 1.6655–1 Addition to the tax in the case of a corporation.

(a) *In general.* Section 6655 imposes an addition to the tax under chapter 1 of the Internal Revenue Code in the case of any underpayment of estimated tax by a corporation. An addition to tax due to the underpayment of estimated taxes is determined by applying the underpayment rate established under section 6621 to the amount of the underpayment, for the period of the underpayment. This addition to the tax is in addition to any applicable criminal penalties and is imposed whether or not there was reasonable cause for the underpayment.

(b) *Amount of underpayment.* The amount of the underpayment for any required installment is the excess of—

(1) The required installment; over

(2) The amount, if any, of the installment paid on or before the last date prescribed for such payment.

(c) *Period of the underpayment.* The period of the underpayment of any required installment runs from the date the installment was required to be paid to the 15th day of the 3rd month following the close of the taxable year, or to the date such underpayment is paid, whichever is earlier. For purposes of determining the period of the underpayment a payment of estimated tax will be credited against unpaid required installments in the order in which such installments are required to be paid.

(d) *Amount of required installment*—(1) *In general.* Except as otherwise provided in this section and §§ 1.6655–2 through 1.6655–7, the amount of any required installment is 25 percent of the lesser of—

(i) 100 percent of the tax shown on the return for the taxable year (or, if no return is filed, 100 percent of the tax for such year); or

(ii) 100 percent of the tax shown on the return for the preceding taxable year.

(2) *Exception.* This paragraph (d)(1)(ii) does not apply if the preceding taxable year was not a taxable year of 12 months or the corporation did not file a return for the preceding taxable year showing a liability for tax.

(e) *Large corporation required to pay 100 percent of current year tax*—(1) *In general.* Except as provided in paragraph (e)(2) of this section, paragraph (d)(1)(ii) of this section does not apply in the case of a large corporation (as defined in § 1.6655–4).

(2) *May use last year's tax for first installment.* Paragraph (e)(1) of this section does not apply for purposes of determining the amount of the 1st required installment for any taxable year. Any reduction in such 1st installment by reason of the preceding sentence is recaptured by increasing the amount of the next required installment determined under paragraph (d)(1)(i) of this section by the amount of such reduction and, if the next required installment is reduced by use of the annualized income installment method under § 1.6655–2 or the adjusted seasonal installment method under § 1.6655–3, by increasing subsequent required installments determined under paragraph (d)(1)(i) of this section to the extent that the reduction has not previously been recaptured.

(f) *Required installment due dates*—(1) *Number of required installments.* Unless otherwise provided, corporations must make 4 required installments for each taxable year.

(2) *Time for payment of installments*—(i) *Calendar year.* Unless otherwise provided, in the case of a calendar year taxpayer, the due dates of the required installments are as follows:

1st	April 15
2nd	June 15
3rd	September 15
4th	December 15

(ii) *Fiscal year*. In the case of a taxpayer other than a calendar year taxpayer, the due dates of the required installments are as follows:

1st 15th day of 4th month of the taxable year
2nd 15th day of 6th month of the taxable year
3rd 15th day of 9th month of the taxable year
4th 15th day of 12th month of the taxable year

(iii) *Short taxable year*. See § 1.6655–5 for rules regarding required installments for corporations with a short taxable year.

(iv) *Partial month*. Except as otherwise provided, for purposes of determining the due date of any required installment, a partial month is treated as a full month.

(g) *Definitions*. (1) The term *tax* as used in this section and §§ 1.6655–2 through 1.6655–7 means the excess of—

(i) The sum of—

(A) The tax imposed by section 11, section 1201(a), or subchapter L of chapter 1 of the Internal Revenue Code, whichever is applicable;

(B) The tax imposed by section 55; plus

(C) The tax imposed by section 887; over

(ii) The credits against tax provided by part IV of subchapter A of chapter 1 of the Internal Revenue Code.

(2)(i) In the case of a foreign corporation subject to taxation under section 11, section 1201(a), or subchapter L of chapter 1 of the Internal Revenue Code, the tax imposed by section 881 is treated as a tax imposed by section 11.

(ii) In the case of a partnership that is treated, pursuant to regulations issued under section 1446(f)(2), as a corporation for purposes of this section, the tax imposed by section 1446 is treated as a tax imposed by section 11.

(iii) Unless otherwise provided in the Internal Revenue Code or Treasury regulations, for purposes of the definition of ''tax'' as used in this section, a recapture of tax, such as a recapture provided by section 50(a)(1)(A), and any other similar provision, is not considered to be a tax imposed by section 11.

(iv) For the purposes of paragraph (d) of this section, the return for the preceding taxable year is the Federal income tax return for such taxable year that is required by section 6012(a)(2). However, if an amended Federal income tax return has been filed before the due date of an installment, then the return for the preceding taxable year is the Federal income tax return as amended. If an amended Federal income tax return has been filed on or after the due date for an installment, then the return for the preceding taxable year does not include for such installment period the Federal income tax return as amended subsequent to the due date for such installment. Paragraph (d) of this section will apply without regard to whether the taxpayer's Federal income tax return for the preceding taxable year is filed in a timely manner.

(h) *Special rules for consolidated returns* For special rules relating to the determination of the amount of the underpayment in the case of a corporation whose income is included in a consolidated return, see § 1.1502–5(b).

(i) *Overpayments applied to subsequent taxable year's estimated tax*—(1) *In general*. If a taxpayer elects under the provisions of sections 6402(b) and 6513(d) and the regulations to apply an overpayment in year one against the estimated tax liability for year two, the overpayment will be applied to the required installment payments for year two in the order due and to the extent necessary to satisfy such installments, similar to the manner in which an actual overpayment of one installment is carried forward to the next installment. No interest is accrued or paid on an overpayment if the election to apply the overpayment against estimated tax is made.

(2) *Subsequent examinations*. If a deficiency is determined in an examination of a return for a taxable year that originally reflected an overpayment that was applied against estimated tax for the succeeding taxable year, interest on the deficiency will not begin to accrue on an amount applied until that amount is used to satisfy a required estimated tax payment in such taxable year. Regardless of whether the taxpayer anticipated the application of such overpayment from the prior taxable year in calculating and paying its

required estimated tax installment liabilities for the current taxable year, the subsequently determined underpayment and interest computation thereon will not change the taxpayer's original election to apply the overpayment against the estimated tax liability of the succeeding taxable year. Any changes to the usage of the original overpayment from the prior taxable year are hypothetical only and solely for the purpose of computing deficiency interest. Overpayment interest will not be impacted. For further guidance, see Rev. Rul. 99–40 (1999–2 CB 441), (see § 601.601(d)(2)(ii)(*b*) of this chapter).

(j) *Examples.* The method prescribed in paragraphs (d) through (g) of this section is illustrated by the following examples:

Example 1. (i) X, a calendar year corporation, estimates its tax liability for its taxable year ending December 31, 2009, will be $85,000. X is not a large corporation as defined in section 6655(g)(2) and § 1.6655–4. X reported a liability of $74,900 on its return for the taxable year ended December 31, 2008, with no credits against tax. X paid four installments of estimated tax, each in the amount of $18,725 (25 percent of $74,900), on April 15, 2009, June 15, 2009, September 15, 2009, and December 15, 2009, respectively. X reported a tax liability of $88,900 on its return due March 15, 2010. X had a $5,000 credit against tax for tax year 2009 as provided by part IV of subchapter A of chapter 1 of the Internal Revenue Code. X did not underpay its estimated tax for tax year 2009 for any of the four installments, determined as follows:

(A) Tax as defined in paragraph (g) of this section for 2009 ($88,900 − $5,000) = $83,900

(B) Tax as defined in paragraph (g) of this section for 2008 = $74,900

(C) 100% of the lesser of this paragraph (j), *Example 1* (i)(A) or (i)(B) = $74,900

(D) Amount of estimated tax required to be paid on or before each installment date (25% of $74,900) = $18,725

(E) Deduct amount paid on or before each installment date = $18,725

(F) Amount of underpayment for each installment date = $0

(ii) [Reserved]

Example 2. (i) *Facts.* Y, a calendar year corporation, estimates its tax liability for its taxable year ending December 31, 2009, will be $70,000. Y is not a large corporation as defined in section 6655(g)(2) and § 1.6655–4. Y reported a Federal income tax liability of $90,000 for its taxable year ending December 31, 2008. Y paid no installment of estimated tax on or before April 15, 2009, June 15, 2009, or September 15, 2009, but made a payment of $63,000 on December 15, 2009. On March 15, 2010, Y filed its income tax return showing a tax of $70,000. Y had no credits against tax for tax year 2009. Of the $63,000 paid by Y on December 15, 2009, $17,500 is applied to each of the first three installments due on April 15, June 15, and September 15, 2009, and the remaining $10,500 is applied to the fourth installment. Y has an underpayment of estimated tax for each of the first three installments of $17,500 and for the fourth installment of $7,000. The addition to tax under section 6655(a) is computed as follows:

(A) Tax as defined in paragraph (g) of this section for 2009 = $70,000

(B) Tax as defined in paragraph (g) of this section for 2008 = $90,000

(C) 100% of the lesser of this paragraph (j), *Example 2* (i)(A) or (i)(B) = $70,000

(D) Amount of estimated tax required to be paid on or before each installment date (25% of $70,000) = $17,500

(E) Amount paid on or before the first, second, and third installment dates = $0

(F) Amount paid on or before the fourth installment date = $63,000

(G) Amount of underpayment for each of the first, second, and third installment dates = $17,500

(H) Amount of underpayment for the fourth installment date = $7,000

(ii) *Addition to tax.* Assuming that neither the annualized income installment method nor the adjusted seasonal installment method described in §§ 1.6655–2 and 1.6655–3 would result in a lower payment for any installment period, and the addition to tax is computed under section 6621(a)(2) at the rate of 8 percent per annum for the applicable periods of underpayment, the addition to tax is determined as follows:

(A) First installment (underpayment period 4–16–09 through 12–15–09), computed as $244/365 \times \$17,500 \times 8\% = \$936$

(B) Second installment (underpayment period 6–16–09 through 12–15–09), computed as $183/365 \times \$17,500 \times 8\% = \$702$

(C) Third installment (underpayment period 9–16–09 through 12–15–09), computed as $91/365 \times \$17,500 \times 8\% = \$349$

(D) Fourth installment (underpayment period 12–16–09 through 3–15–10), computed as $90/365 \times \$7,000 \times 8\% = \$138$

(E) Total of this paragraph (j), *Example 2* (ii)(A) through (D) = $2,125

(k) *Effective/applicability date.* This section applies to taxable years beginning after September 6, 2007.

[T.D. 9347, 72 FR 44349, Aug. 7, 2007]

§ 1.6655–2 Annualized income installment method.

(a) *In general.* In the case of any required installment, if the corporation establishes that the annualized income installment determined under this section, or the adjusted seasonal installment determined under § 1.6655–3, is less than the amount determined under § 1.6655–1—

(1) The amount of such required installment is the annualized income installment (or, if less, the adjusted seasonal installment); and

(2) Any reduction in a required installment resulting from the application of this section will be recaptured by increasing the amount of the next required installment determined under § 1.6655–1 by the amount of such reduction (and, if the next required installment is similarly reduced, by increasing subsequent required installments to the extent that the reduction has not previously been recaptured).

(b) *Determination of annualized income installment—in general.* In the case of any required installment, the annualized income installment is the excess (if any) of—

(1) The product of the applicable percentage and the tax (after reducing the annualized tax by the amount of any allowable credits) for the taxable year computed by annualizing the taxable income and alternative minimum taxable income—

(i) For the first 3 months of the taxable year, in the case of the first required installment;

(ii) For the first 3 months of the taxable year, in the case of the second required installment;

(iii) For the first 6 months of the taxable year, in the case of the third required installment; and

(iv) For the first 9 months of the taxable year, in the case of the fourth required installment; over

(2) The aggregate amount of any prior required installments for the taxable year.

(c) *Special rules*—(1) *Applicable percentage.* Except as otherwise provided in § 1.6655–5(d) with respect to short taxable years—

In the case of the following required installments	The applicable percentage is
1st	25
2nd	50
3rd	75
4th	100

(2) *Partial month.* Except as otherwise provided, for purposes of paragraph (b) of this section a partial month is treated as a month.

(3) *Annualization period not a short taxable year.* An annualization period is not treated as a short taxable year for purposes of determining the taxable income of an annualization period.

(d) *Election of different annualization periods.* (1) If the taxpayer timely files Form 8842, ‘‘Election to Use Different Annualization Periods for Corporate Estimated Tax,’’ in accordance with section 6655(e)(2)(C)(iii), and elects Option 1—

(i) Paragraph (b)(1)(i) of this section will be applied by using the language ‘‘2 months’’ instead of ‘‘3 months’’;

(ii) Paragraph (b)(1)(ii) of this section will be applied by using the language ‘‘4 months’’ instead of ‘‘3 months’’;

(iii) Paragraph (b)(1)(iii) of this section will be applied by using the language ‘‘7 months’’ instead of ‘‘6 months’’; and

(iv) Paragraph (b)(1)(iv) of this section will be applied by using the language ‘‘10 months’’ instead of ‘‘9 months’’.

(2) If the taxpayer timely files Form 8842, in accordance with section 6655(e)(2)(C)(iii), and elects Option 2—

(i) Paragraph (b)(1)(ii) of this section will be applied by using the language ‘‘5 months’’ instead of ‘‘3 months’’;

(ii) Paragraph (b)(1)(iii) of this section will be applied by using the language ‘‘8 months’’ instead of ‘‘6 months’’; and

(iii) Paragraph (b)(1)(iv) of this section will be applied by using the language ‘‘11 months’’ instead of ‘‘9 months’’.

(3) The application of the annualized income installment method is illustrated by the following example:

Example. (i) ABC, a calendar year corporation, had a taxable year of less than twelve months for tax year 2008 and no credits against tax for tax year 2009. ABC made an estimated tax payment of $15,000 on the installment dates of April 15, 2009, June 15, 2009, September 15, 2009, and December 15, 2009, respectively. Assume that, under paragraph (d)(1) of this section, ABC elected Option 1 by timely filing Form 8842, in accordance with section 6655(e)(2)(C)(iii), and determined that its taxable income for the first 2, 4, 7 and 10 months was $25,000, $64,000,

$125,000, and $175,000 respectively. The income for each period is annualized as follows:

$25,000 × 12/2 = $150,000
$64,000 × 12/4 = $192,000
$125,000 × 12/7 = $214,286
$175,000 × 12/10 = $210,000

(ii)(A) To determine whether the installment payment made on April 15, 2009, equals or exceeds the amount that would have been required to have been paid if the estimated tax were equal to 100 percent of the tax computed on the annualized income for the 2-month period, the following computation is necessary:

(*1*) Annualized income for the 2 month period = $150,000

(*2*) Tax on this paragraph (d)(3), *Example* (ii)(A)(*1*) = $41,750

(*3*) 100% of this paragraph (d)(3), *Example* (ii)(A)(*2*) = $41,750

(*4*) 25% of this paragraph (d)(3), *Example* (ii)(A)(*3*) = $10,438

(B) Because the total amount of estimated tax that was timely paid on or before the first installment date ($15,000) exceeds the amount required to be paid on or before this date if the estimated tax were 100 percent of the tax determined by placing on an annualized basis the taxable income for the first 2-month period ($10,438), the exception described in paragraphs (a) and (b) of this section applies, and no addition to tax will be imposed for the installment due on April 15, 2009.

(iii)(A) To determine whether the installment payments made on or before June 15, 2009, equal or exceed the amount that would have been required to have been paid if the estimated tax were equal to 100 percent of the tax computed on the annualized income for the 4-month period, the following computation is necessary:

(*1*) Annualized income for the 4 month period = $192,000

(*2*) Tax on this paragraph (d)(3), *Example* (iii)(A)(*1*) = $58,130

(*3*) 100% of this paragraph (d)(3), *Example* (iii)(A)(*2*) = $58,130

(*4*) 50% of this paragraph (d)(3), *Example* (iii)(A)(*3*) less $10,438 (amount due with the first installment) = $18,627

(B) Because the total amount of estimated tax actually paid on or before the second installment date ($19,562 ($15,000 second required installment payment plus $4,562 overpayment of first required installment)) exceeds the amount required to be paid on or before this date if the estimated tax were 100 percent of the tax determined by placing on an annualized basis the taxable income for the first 4-month period ($18,627), the exception described in paragraphs (a) and (b) of this section applies, and no addition to tax will be imposed for the installment due on June 15, 2009.

(iv)(A) To determine whether the installment payments made on or before September 15, 2009, equal or exceed the amount that would have been required to have been paid if the estimated tax were equal to 100 percent of the tax computed on the annualized income for the 7-month period, the following computation is necessary:

(*1*) Annualized income for the 7 month period = $214,286

(*2*) Tax on this paragraph (d)(3), *Example* (iv)(A)(*1*) = $66,821

(*3*) 100% of this paragraph (d)(3), *Example* (iv)(A)(*2*) = $66,821

(*4*) 75% of this paragraph (d)(3), *Example* (iv)(A)(*3*) less $29,065 (amount due with the first and second installment) = $21,051

(B) Because the total amount of estimated tax actually paid on or before the third installment date ($15,935 ($15,000 third required installment payment plus $935 overpayment of second required installment)) does not equal or exceed the amount required to be paid on or before this date if the estimated tax were 100 percent of the tax determined by placing on an annualized basis the taxable income for the first 7-month period ($21,051), the exception described in paragraphs (a) and (b) of this section does not apply, and an addition to tax will be imposed with respect to the underpayment of the September 15, 2009, installment unless another exception applies to this installment payment.

(v)(A) To determine whether the installment payments made on or before December 15, 2009, equal or exceed the amount that would have been required to have been paid if the estimated tax were equal to 100 percent of the tax computed on the annualized income for the 10-month period, the following computation is necessary:

(*1*) Annualized income for the 10 month period = $210,000

(*2*) Tax on this paragraph (d)(3), *Example* (v)(A)(*1*) = $65,150

(*3*) 100% of this paragraph (d)(3), *Example* (v)(A)(*2*) = $65,150

(*4*) 100% of this paragraph (d)(3), *Example* (v)(A)(*3*) less $50,116 (amount due with the first, second and third installment) = $15,034

(B) Because the total amount of estimated tax payments made on or before the fourth installment date that is available to be applied to the estimated tax due for the fourth installment ($9,884 ($15,000 fourth required installment payment less $5,116 underpayment for the third installment of estimated tax ($21,051 third installment of estimated tax due less $15,935 payments available to be applied to the third installment of estimated tax))) does not equal or exceed the amount required to be paid on or before this date if the estimated tax were 100 percent of the tax determined by placing on an annualized basis the taxable income for the first 10-month period ($15,034), the exception described in paragraphs (a) and (b) of this section does not apply, and an addition to tax will be imposed with respect to the underpayment of the December 15, 2009, installment unless another exception applies to this installment payment.

(vi) Assuming that no other exceptions apply and the addition to tax is computed under section 6621(a)(2) at the rate of 8 percent per annum for the applicable periods of underpayment, the amount of the addition to tax is as follows:

(A) First installment (no underpayment) = $0

(B) Second installment (no underpayment) = $0

(C) Third installment (underpayment period 9–16–09 through 12–15–09), computed as $\frac{91}{365} \times \$5{,}116 \times 8\% = \$102$

(D) Fourth installment (underpayment period 12–16–09 through 3–15–10), computed as $\frac{90}{365} \times \$5{,}150 \times 8\% = \$102$

(E) Total of this paragraph (d)(3), *Example* (vi)(A) through (D) = $204

(e) *52–53 week taxable year*. (1) Generally, except as provided in the alternative rule in paragraph (e)(4) of this section, in the case of a taxpayer whose taxable year constitutes 52 or 53 weeks in accordance with section 441(f), the rules prescribed by § 1.441–2 are applicable in determining—

(i) Whether a taxable year is a taxable year of 12 months; and

(ii) When the 2-, 3-, 4-, 5-, 6-, 7-, 8-, 9-, 10-, or 11-month period (whichever is applicable) commences and ends for purposes of paragraphs (b)(1), (d)(1) and (d)(2) of this section.

(2) If a taxpayer employs four 13-week periods or thirteen 4-week accounting periods and the end of any accounting period employed by the taxpayer does not correspond to the end of the 2-, 3-, 4-, 5-, 6-, 7-, 8-, 9-, 10-, or 11-month period (whichever is applicable), then, provided the taxpayer has at least one full 4-week or 13-week accounting period, as appropriate, within the applicable period, annualized taxable income for the applicable period is—

(i) [(x/(y*13))*z], in the case of a taxpayer using four 13-week periods, if—

(A) x = Taxable income for the number of full 13-week periods in the applicable period;

(B) y = The number of full 13-week periods in the applicable period; and

(C) z = The number of weeks in the taxable year; or

(ii) [(x/(y*4))*z], in the case of a taxpayer using thirteen 4-week periods, if—

(A) x = Taxable income for the number of full 4-week periods in the applicable period;

(B) y = The number of full 4-week periods in the applicable period; and

(C) z = The number of weeks in the taxable year.

(3) If a taxpayer employs four 13-week periods and the taxpayer does not have at least one 13-week period within the applicable 2-, 3-, 4-, 5-, 6-, 7-, 8-, 9-, 10-, or 11-month period, the taxpayer is permitted to determine annualized taxable income for the applicable period based upon—

(i) The taxable income for the number of weeks in the applicable period; or

(ii) The taxable income for the full 13-week periods that end before the due date of the required installment.

(4) As an alternative to using the 52/53 week taxable year rules provided in paragraphs (e)(1), (e)(2), and (e)(3) of this section, a taxpayer whose taxable year constitutes 52 or 53 weeks in accordance with section 441(f) may base its annualization period on the month that ends closest to the end of its applicable 4-week period or 13-week period that ends within the applicable annualization period. This alternative may only be used if it is used for determining annualization periods for all required installments for the taxable year.

(5) The following examples illustrate the rules of this paragraph (e):

Example 1. Corporation ABC, an accrual method taxpayer, uses a 52/53 week year-end ending on the last Friday in December and uses four thirteen-week periods. For its year beginning December 28, 2007, ABC uses the annualized income installment method under section 6655(e)(2)(A)(i) to calculate all of its required installments. For purposes of computing its first and second required installments, the first 3 months of A's taxable year under paragraph (b)(1)(i) of this section will end on March 28th, the thirteenth Friday of ABC's taxable year. For purposes of its third required installment, the first 6 months of ABC's taxable year will end on June 27th, the twenty-sixth Friday of ABC's taxable year. For purposes of its fourth required installment, the first 9 months of ABC's taxable year will end on September

26th, the thirty-ninth Friday of ABC's taxable year.

Example 2. Same facts as *Example 1* except that ABC uses thirteen four-week periods and there are 52 weeks during ABC's taxable year beginning December 28, 2007, and ending December 26, 2008. For purposes of computing ABC's first and second required installments, ABC's annualized taxable income for the first three months will be the taxable income for the first three four-week periods of ABC's taxable year (December 28, 2007, through March 21, 2008) divided by 12 (number of full four-week periods in the first three months (3) multiplied by 4) and multiplied by 52 (the number of weeks in the taxable year). For purposes of computing ABC's third required installment, ABC's annualized taxable income for the first six months will be the taxable income for the first six four-week periods of ABC's taxable year (December 28, 2007, through June 13, 2008) divided by 24 and multiplied by 52. For purposes of computing ABC's fourth required installment, ABC's annualized taxable income for the first nine months will be the taxable income for the first nine four-week periods of ABC's taxable year (December 28, 2007, through September 5, 2008) divided by 36 and multiplied by 52.

Example 3. Same facts as *Example 1* except that ABC uses the alternative method under paragraph (e)(4) of this section for computing its required installments for 2008. For purposes of computing its first and second required installments, the first three months of ABC's taxable year under paragraph (b)(1)(i) of this section will end on March 31, 2008, the month that ends closest to the end of ABC's applicable thirteen-week period for the first and second required installments. For purposes of ABC's third required installment, the first six months of ABC's taxable year will end on June 30, 2008, the month that ends closest to the end of ABC's applicable thirteen-week period for the third required installment. For purposes of ABC's fourth required installment, the first nine months of ABC's taxable year will end on September 30, 2008, the month that ends closest to the end of ABC's applicable thirteen-week period for the fourth required installment.

(f) *Determination of taxable income for an annualization period*—(1) *In general.* This paragraph (f) applies for purposes of determining the applicability of the exception described in paragraphs (a) and (b) of this section (relating to the annualization of income) and the exception described in §1.6655–3 (relating to annualization of income for corporations with seasonal income). An item of income, deduction, gain or loss is to be taken into account in determining the taxable income and alternative minimum taxable income (and applicable tax and alternative minimum tax) for an annualization period in the manner provided in this paragraph (f). An item may not be taken into account in determining taxable income for any annualization period unless the item is properly taken into account by the last day of that annualization period and the item is properly taken into account in determining the taxpayer's taxable income and alternative minimum taxable income (and applicable tax and alternative minimum tax) for the taxable year that includes the annualization period.

(i) *Items of income.* An item of income is taken into account in the annualization period in which the item is properly includible under the method of accounting employed by the taxpayer with respect to the item and in accordance with the appropriate provision of the Internal Revenue Code (for example, section 451 for accrual method taxpayers, section 453 for installment sales or section 460 for long-term contracts).

(ii) *Items of deduction.* An item of deduction is taken into account in the annualization period in which the item is properly deductible under the method of accounting employed by the taxpayer with respect to the item and in accordance with the appropriate provision of the Internal Revenue Code (for example, under the cash receipts and disbursements method of accounting, the deduction must be paid under §1.461–1(a)(1) and be otherwise deductible in computing taxable income; under an accrual method of accounting, the deduction must be incurred under §1.461–1(a)(2) and be otherwise deductible in computing taxable income). Section 170(a)(2) and §1.170A–11(b) (charitable contributions by accrual method corporations) and §1.461–5 (recurring item exception) may not be taken into consideration by an accrual method taxpayer in any annualization period in determining whether an item of deduction has been incurred under §1.461–1(a)(2) during that annualization period.

(iii) *Losses.* An item of loss is to be taken into account during the annualization period in which events have occurred that permit the loss to be taken into account under the appropriate provision of the Internal Revenue Code.

(2) *Certain deductions required to be allocated in a reasonably accurate manner*—(i) *In general.* The following deductions allowed for a taxable year must be allocated throughout the taxable year in a reasonably accurate manner (as defined in paragraph (f)(2)(iii) of this section), regardless of the annualization period in which the item is paid or incurred:

(A) Real property tax deductions.

(B) Employee and independent contractor bonus compensation deductions (including the employer's share of employment taxes related to such compensation).

(C) Deductions under sections 404 (deferred compensation) and 419 (welfare benefit funds).

(D) Items allowed as a deduction for the taxable year by reason of section 170(a)(2) and §1.170A–11(b) (certain charitable contributions by accrual method corporations), §1.461–5 (recurring item exception) or §1.263(a)-4(f) (12-month rule).

(E) Items of deduction designated by the Secretary by publication in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter).

(ii) *Application of the reasonably accurate manner requirement to certain charitable contributions, recurring items, and 12-month rule items.* For purposes of paragraph (f)(2)(i)(D) of this section, the total amount of the item deducted in the computation of taxable income for the taxable year must be allocated in a reasonably accurate manner, notwithstanding the fact that section 170(a)(2) and §1.170A–11(b), §1.461–5, or §1.263(a)–4(f) applies to only a portion of the total amount of the item deducted for the taxable year. For example, if a portion of a taxpayer's rebate liabilities are deducted in the computation of taxable income under the recurring item exception, all rebate liabilities deducted in the computation of taxable income for the taxable year must be allocated in a reasonably accurate manner.

(iii) *Reasonably accurate manner defined.* (A) An item is allocated throughout the taxable year in a reasonably accurate manner if the item is allocated ratably throughout the taxable year or if the allocation provides a reasonably accurate estimate of taxable income for the taxable year based upon the facts known as of the end of the annualization period. In determining that an allocation of an item provides a reasonably accurate estimate of taxable income for the taxable year, relevant considerations include—

(*1*) The extent to which the allocation is consistent with the taxpayer's accounting for the item on its non-tax books and records;

(*2*) The extent to which the allocable portion of the item becomes fixed and determinable (under §1.461–1(a)(2)) during the applicable annualization period; and

(*3*) The extent to which the allocation, if compared to the ratable allocation of the item, results in a better matching of the item of deduction to revenue, earnings, the use of property or the provision of services occurring during the annualization period.

(B) None of the relevant considerations above override the general requirement that the allocation must be done in a reasonably accurate manner based upon the facts known as of the end of the annualization period. For example, the fact that a liability for an annual expense becomes fixed and determinable during an annualization period will not establish that allocating all of the expense to that annualization period has been done in a reasonably accurate manner if the facts known as of the end of the annualization period indicate otherwise.

(iv) *Special rule for certain real property tax liabilities.* Notwithstanding paragraph (f)(2)(iii) of this section, real property tax liabilities for which an election under section 461(c) is in effect must be allocated ratably throughout the taxable year for purposes of this section.

(v) *Examples.* Unless otherwise stated, the following examples assume that the taxpayer uses the 3–3–6–9 annualization period:

Example 1. (i) Corporation ABC, a calendar year taxpayer, uses an accrual method of accounting and the annualized income installment method under section 6655(e)(2)(A)(i) to calculate all of its required installment payments for its 2008 taxable year. ABC has adopted a plan under which ABC pays an annual bonus to its employees. As of March 31, 2008, ABC estimates that it will pay a year-end bonus of $500,000 to its employees if earnings remain constant throughout the tax year. ABC does not pay any of the estimated bonus liability as of March 31, 2008. On October 31, 2008, ABC declares a $600,000 bonus to its employees which is paid out on November 15, 2008, and properly deducted in ABC's December 31, 2008, tax year. No other bonus liabilities are incurred by ABC during the tax year.

(ii) Under the general rule provided in paragraph (f)(2)(i) of this section, ABC is required to allocate its employee bonus liability in a reasonably accurate manner for annualization purposes. Under paragraph (f)(2)(iii) of this section, ABC's employee bonus liability will be deemed to be allocated in a reasonably accurate manner if the item is allocated ratably throughout the taxable year. Therefore, ABC is permitted to recognize a $150,000 bonus deduction (one quarter of the $600,000 bonus liability properly recognized by ABC in the tax year ending December 31, 2008) in the first annualization period ending March 31, 2008.

Example 2. (i) Corporation ABC, a calendar year taxpayer, uses an accrual method of accounting and the annualized income installment method under section 6655(e)(2)(A)(i) to calculate all of its required installment payments for its 2008 taxable year. ABC has adopted a plan under which ABC pays an annual bonus to its employees. ABC's employee bonus plan generally calls for an annual bonus equal to 2% of earnings. A bonus reserve for this amount is reported each quarter in ABC's non-tax books and records. ABC's quarterly revenues throughout the year are $10,000,000; $6,000,000; $7,000,000; and $7,000,000 respectively. As of March 31, 2008, ABC estimates that it will pay a year-end bonus of $800,000 ($10,000,000 × 4 × 2%) to its employees if earnings remain constant throughout the year. ABC does not pay any of the estimated bonus payment as of March 31, 2008. On December 31, 2008, ABC declares a $600,000 bonus to its employees which is paid out on January 15, 2009, and properly deducted in ABC's December 31, 2008, tax year.

(ii) Under the general rule provided in paragraph (f)(2)(i) of this section, ABC must allocate its employee bonus liability in a reasonably accurate manner for annualization purposes. Under paragraph (f)(2)(iii) of this section, ABC's employee bonus liability will be deemed to be allocated in a reasonably accurate manner if the allocation provides a reasonable estimate of taxable income based upon the facts known as of the end of the annualization period. Based upon its earnings activities and other information available as of March 31, 2008, ABC estimated that its total deduction for employee bonuses for the taxable year ending December 31, 2008, would be $800,000 ($10,000,000 first quarter earnings × 4 × 2%). Allocating $200,000 ($10,000,000 × 2%) of ABC's annual bonus liability of $600,000 to ABC's first quarter based upon earnings during the quarter represents a better matching of ABC's bonus expense to earnings in the quarter as compared to allocating $150,000 to ABC's first quarter under a ratable accrual method and is consistent with the allocation provided in ABC's non-tax books and records. Accordingly, allocating ABC's employee bonus deductions based upon ABC's earnings will be considered allocated in a reasonably accurate manner.

Example 3. (i) Corporation ABC, a calendar year taxpayer, uses an accrual method of accounting and the annualized income installment method under section 6655(e)(2)(A)(i) to calculate all of its required installment payments for its 2008 taxable year. ABC has adopted a plan under which ABC pays a bonus to its employees each quarter based upon earnings for that quarter. On March 31, 2008, ABC pays out $2,000,000 to its employees as a quarterly bonus based upon the earnings of ABC for the period January 1, 2008, through March 31, 2008. The $2,000,000 bonus is recognized as an expense on ABC's audited financial statements in the quarter ending March 31, 2008. As of March 31, 2008, ABC anticipates that its earnings will continue throughout the year resulting in future quarterly bonus payments in 2008 similar to the $2,000,000 first quarter payment.

(ii) Under the general rule provided in paragraph (f)(2)(i) of this section, ABC is required to allocate its employee bonus liability in a reasonably accurate manner for annualization purposes. Under paragraph (f)(2)(iii) of this section , ABC's employee bonus liability will be deemed to be allocated in a reasonably accurate manner if the item is allocated ratably throughout the taxable year. Therefore, ABC may recognize a $500,000 bonus deduction (one quarter of the $2,000,000 bonus liability properly recognized by ABC in the tax year ending December 31, 2008) in the first annualization period ending March 31, 2008 (as well as one quarter of any additional bonus liability properly recognized by ABC in the tax year ending December 31, 2008).

(iii) In addition, paragraph (f)(2)(iii) of this section provides that an allocation will be considered reasonable if the allocation provides an accurate estimate of taxable income for the taxable year based upon the facts known as of the end of the annualization period. Based upon its earnings activities and other information available as of March 31, 2008, ABC estimates that its total deduction for employee bonuses for the taxable year ending December 31, 2008, would be $8,000,000. In addition, the $2,000,000 bonus liability became fixed and determinable during the first quarter. Allocating $2,000,000 to ABC's first quarter earnings is also consistent with ABC's non-tax books and records and represents a better matching of ABC's bonus expense to earnings in the quarter as compared to a ratable accrual. Accordingly, allocating ABC's bonus liability based upon earnings will be considered a reasonably accurate manner for estimated tax purposes.

Example 4. (i) Corporation ABC, a calendar year taxpayer, uses an accrual method of accounting with the recurring item exception and the annualized income installment method under section 6655(e)(2)(A)(i) to calculate all of its required installment payments for its 2009 taxable year. ABC regularly incurs rebate obligations related to the sale of its products. Rebate coupons that are received and validated by ABC are generally paid in the following month. During the tax year ending December 31, 2009, ABC received, validated and paid $400,000 in rebates. In addition, as of the end of December 31, 2009, ABC had received and validated $100,000 in rebate claims that were paid in January of 2010 and deducted in ABC's December 31, 2009, tax year under the recurring item exception. Therefore, ABC properly recognized a $500,000 rebate liability deduction on ABC's December 31, 2009, tax return.

(ii) Under the rule provided in paragraph (f)(2)(ii) of this section, an item must be allocated in a reasonably accurate manner if any portion of the item is deducted under the recurring item exception. Therefore, ABC will be required to allocate its entire $500,000 rebate liability deduction in a reasonably accurate manner as defined in paragraph (f)(2)(iii) of this section.

(3) *Special rules*—(i) *Advance payments*—(A) *Advance payments under §1.451–5(b)(1)(ii).* An advance payment for which the taxpayer uses the method of accounting provided in §1.451–5(b)(1)(ii) is includible in computing taxable income for an annualization period in accordance with that method of accounting except that, if §1.451–5(c) applies, any amount not included in computing taxable income by the end of the second taxable year following the year in which substantial advance payments are received, and not previously included in accordance with the taxpayer's accrual method of accounting, is includible in computing taxable income on the last day of such second taxable year.

(B) *Advance payments under Rev. Proc. 2004–34.* An advance payment for which the taxpayer uses the Deferral Method provided in section 5.02 of Rev. Proc. 2004–34 (2004–1 CB 991), (see §601.601(d)(2)(ii)(*b*) of this chapter) is includible in computing taxable income for an annualization period in accordance with that method of accounting, except that any amount not included in computing taxable income by the end of the taxable year succeeding the taxable year of receipt is includible in computing taxable income on the last day of such succeeding taxable year.

(ii) *Extraordinary items*—(A) *In general.* In general, extraordinary items must be taken into account after annualizing the taxable income for the annualization period. For purposes of the preceding sentence an extraordinary item is any item identified in §1.1502–76(b)(2)(ii)(C)(1), (2), (3), (4), (7), and (8), a net operating loss carryover, a section 481(a) adjustment, net gain or loss from the disposition of 25 percent or more of the fair market value of a taxpayer's business assets during a taxable year, and any other item designated by the Secretary by publication in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(b) of this chapter).

(B) *De minimis extraordinary items.* A taxpayer may treat any *de minimis* extraordinary item, other than a net operating loss carryover or section 481(a) adjustment, as an item under the general rule of paragraph (f)(1) of this section rather than an extraordinary item as provided for in paragraph (f)(3)(ii) of this section. A *de minimis* extraordinary item is any item identified in paragraph (f)(3)(ii)(A) of this section resulting from a transaction in which the total extraordinary items resulting from such transaction is less than $1,000,000.

(C) *Special rule for net operating loss deductions and section 481(a) adjustments.* For purposes of paragraph (f)(3)(ii) of this section, a taxpayer must treat a net operating loss deduction and section 481(a) adjustment as extraordinary items arising on the first day of the tax year in which the item is taken into account in determining taxable income. Notwithstanding the preceding sentence, a taxpayer may choose to treat the portion of a section 481(a) adjustment recognized during the tax year of the accounting method change as an extraordinary item arising on the date the Form 3115, ''Application for Change in Accounting Method,'' requesting the change was filed with the national office of the Internal Revenue Service.

(iii) *Credits*—(A) *Current year credits*. With respect to a current year credit, the items upon which the credit is computed are annualized, the amount of the credit is computed based on the annualized items, and the amount of the credit is deducted from the annualized tax. For example, for an annualization period consisting of three months in a full 12-month taxable year, the items upon which the credit is based that are taken into account for the three month period are multiplied by four, the credit is determined based on the annualized amount of the items, and the credit reduces the annualized tax.

(B) *Credit carryovers*. Any credit carryover to the current taxable year is taken into account in computing an annualized income installment only after annualizing the taxable income for the annualization period and computing the applicable tax, and before applying the applicable percentage.

(iv) *Depreciation and amortization*—(A) *Estimated annual depreciation and amortization*. In general, in determining taxable income for any annualization period, a proportionate amount of the taxpayer's estimated annual depreciation and amortization (depreciation) expense may be taken into account. For purposes of the preceding sentence, estimated annual depreciation expense is the estimated depreciation expense to be properly taken into account in determining the taxpayer's taxable income for the taxable year. In determining the estimated annual depreciation expense, a taxpayer may take into account purchases, sales or other dispositions, changes in use, additional first-year depreciation and expense deductions and section 179 or any similar provision, and other events that, based on all the relevant information available as of the last day of the annualization period (such as capital spending budgets, financial statement data and projections, or similar reports that provide evidence of the taxpayer's capital spending plans for the current taxable year), are reasonably expected to occur or apply during the taxable year.

(B) *Safe harbors*—(*1*) *Proportionate depreciation allowance*. In determining taxable income for any annualization period, in lieu of the rule provided in paragraph (f)(3)(iv)(A) of this section a taxpayer may take into account a proportionate amount of the depreciation and amortization (depreciation) expense, including special depreciation and expense deductions such as those provided for in section 168(k) and section 179 or any similar provision, allowed for the taxable year from—

(*i*) Assets that were in service on the last day of the prior taxable year, are in service on the first day of the current taxable year, and that have not been disposed of during the annualization period;

(*ii*) Assets placed in service during the annualization period and have not been disposed of during that period; and

(*iii*) Assets that were in service on the last day of the prior taxable year and that are disposed of during the annualization period.

(*2*) *90 percent of preceding year's depreciation*. In determining taxable income for any annualization period, in lieu of the general rule provided in paragraph (f)(3)(iv)(A) of this section, a proportionate amount of 90 percent of the amount of depreciation and amortization (depreciation) expense taken on the taxpayer's Federal income tax return for the preceding taxable year may be taken into account. If the taxpayer's preceding taxable year is less than 12 months (a short taxable year), the amount of depreciation expense taken into account is annualized by multiplying the depreciation and amortization for the short taxable year by 12, and dividing the result by the number of months in the short taxable year.

(*3*) *Safe harbor operational rules*. If a taxpayer selects one of the two safe harbors provided in paragraph (f)(3)(iv)(B)(*1*) or paragraph (f)(3)(iv)(B)(*2*) of this section, the taxpayer must use that safe harbor for all depreciation expenses within the annualization period for the annualized income installment. However, a taxpayer may use either the method provided for in paragraph (f)(3)(iv)(A) of this section or a method provided for in this paragraph (f)(3)(iv)(B) of this section for each annualized income installment during the taxable year. For example, a taxpayer may use the safe harbor provided in paragraph (f)(3)(iv)(B)(*1*) of this section for its first annualized income installment and may use the general rule provided in paragraph (f)(3)(iv)(A) of this section for its second annualized income installment.

(C) *Short taxable years.* If the taxable year is, or will be, a short taxable year (based on all relevant information available as of the last day of the annualization period), annual depreciation expense is computed using the rules applicable for computing depreciation during a short taxable year for purposes of determining the annual depreciation expense to be allocated to an annualization period. For this purpose, the rules applicable for computing depreciation during a short taxable year are applied on the basis of the date the taxable year is expected to end based on all relevant information available as of the last day of the annualization period. See Rev. Proc. 89–15 (1989–1 CB 816) for computing depreciation expense under section 168 (see §601.601(d)(2)(ii)(*b*) of this chapter). An annualization period is not treated as a short taxable year for purposes of determining the depreciation expense for an annualization period. See paragraph (c)(3) of this section.

(v) *Distributive share of items*—(A) *Member of partnership.* In determining a partner's distributive share of partnership items that must be taken into account during an annualization period, the rules set forth in §1.6654–2(d)(2) are applicable.

(B) *Treatment of subpart F income and income under section 936(h)*—(*1*) *General rule.* Any amounts required to be included in gross income under section 936(h) or section 951(a), and credits properly allocable thereto, are taken into account in computing any annualized income installment in a manner similar to the manner under which partnership inclusions, and credits properly allocable thereto, are taken into account in accordance with paragraph (f)(3)(v)(A) of this section.

(*2*) *Prior year safe harbor*—(i) *General rule.* If a taxpayer elects to have the safe harbor in this paragraph (f)(3)(v)(B)(2) apply for any taxable year, then paragraph (f)(3)(v)(B)(*1*) of this section does not apply; and, for purposes of computing any annualized income installment for the taxable year, the taxpayer is treated as having received ratably during the taxable year items of income and credit described in paragraph (f)(3)(v)(B)(*1*) of this section in an amount equal to 115 percent of the amount of such items shown on the return of the taxpayer for the preceding taxable year (the second preceding taxable year in the case of the first and second required installments for such taxable year).

(ii) *Special rule for noncontrolling shareholder.* If a taxpayer making the election under paragraph (f)(3)(v)(B)(*2*)(*i*) of this section is a noncontrolling shareholder of a corporation, paragraph (f)(3)(v)(B)(*2*)(*i*) of this section is applied with respect to items of such corporation by substituting ''100 percent'' for ''115 percent''. For purposes of paragraph (f)(3)(v)(B)(*2*)(*ii*) of this section, the term *noncontrolling shareholder* means, with respect to any corporation, a shareholder that, as of the beginning of the taxable year for which the installment is being made, does not own within the meaning of section 958(a), and is not treated as owning within the meaning of section 958(b), more than 50 percent by vote or value of the stock in the corporation.

(C) *Dividends from closely held real estate investment trust*—(*1*) *General rule.* Any dividend received from a closely held real estate investment trust by any person that owns, after the application of section 856(d)(5), 10 percent or more by vote or value of the stock or beneficial interests in the trust is taken into account in computing annualized income installments in a manner similar to the manner under which partnership income inclusions are taken into account.

(*2*) *Closely held real estate investment trust.* For purposes of paragraph (f)(3)(v)(C)(*1*) of this section, the term *closely held real estate investment trust* means a real estate investment trust with respect to which 5 or fewer persons own, after the application of section 856(d)(5), 50 percent or more by vote or value of the stock or beneficial interests in the trust.

(D) *Other passthrough entities.* A taxpayer's distributive share of items from a passthrough entity, other than those described in paragraphs (f)(3)(v)(A) and (f)(3)(v)(C) of this section, is taken into account in computing any annualized income installment in a manner similar to the manner under which partnership items are taken into account under paragraph (f)(3)(v)(A) of this section.

(vi) *Alternative minimum taxable income exemption amount.* The alternative minimum taxable income exemption amount provided by section 55(d)(2) is applied after the alternative minimum taxable income for the annualization period is annualized.

(vii) *Examples.* The provisions of this paragraph (f) are illustrated by the following examples. Unless otherwise stated, the following examples assume that the taxpayer uses the 3–3–6–9 annualization period.

Example 1. Expense paid or incurred in the installment period. Corporation ABC, a calendar year taxpayer, uses an accrual method of accounting and the annualized income installment method under section 6655(e)(2)(A)(i) to calculate all of its required installment payments for its 2008 taxable year. ABC has licensed technology from Corporation XYZ. Pursuant to the license agreement, ABC pays a license fee to XYZ equal to $.01 for every dollar of gross receipts earned by ABC. For 2008, ABC projects gross receipts of $200,000,000, of which $100,000,000 is earned by March 31, 2008. Pursuant to paragraph (f)(1) of this section, a license fee expense of $1,000,000 ($100,000,000 × $.01) is incurred by March 31, 2008, and may be taken into account for purposes of determining the taxable income to be annualized in computing ABC's first annualized income installment.

Example 2. Expense not paid or incurred in the installment period. Same facts as *Example 1* except that ABC does not earn any gross receipts by March 31, 2008. In accordance with paragraph (f)(1) of this section, because the license fee expense was not incurred under §1.461–1(a)(2) by the last day of the annualization period, no license fee expense is taken into account for purposes of determining the taxable income to be annualized in computing ABC's first annualized income installment, which is based on the income and deductions from the first three months of the taxable year.

Example 3. Bad debt expense. Corporation ABC, a calendar year taxpayer, uses an accrual method of accounting and the annualized income installment method under section 6655(e)(2)(A)(i) to calculate all of its required installment payments for its 2008 taxable year. As of December 31, 2007, ABC had a $100,000 account receivable due from XYZ related to the sale of goods from ABC to XYZ during 2007. On March 30, 2008, ABC determined that its receivable from XYZ was worthless under section 166 and the regulations. No other receivables were determined to be worthless between January 1, 2008, and March 31, 2008. In accordance with paragraph (f)(1) of this section, a $100,000 bad debt write-off is taken into account for purposes of determining the taxable income to be annualized in computing ABC's first annualized income installment.

Example 4. Bad debt expense. Same facts as *Example 3* except that ABC determines that the receivable from XYZ was worthless under section 166 and the regulations on April 10, 2008. As of March 31, 2008, ABC had not determined that any receivables were worthless under section 166 and the regulations. In accordance with paragraph (f)(1) of this section, the $100,000 bad debt expense attributable to the receivable from XYZ is not taken into account for purposes of determining the taxable income to be annualized in computing ABC's first annualized income installment, which is based on the income and deductions from the first three months of the taxable year, because the receivable from XYZ became worthless after the last day of the annualization period.

Example 5. Employer deductions under section 404 and 419. (i) Corporation ABC, a calendar year taxpayer, uses an accrual method of accounting and uses the annualized income installment method under section 6655(e)(2)(A)(i) to calculate all of its required installment payments for its 2008 taxable year. On March 1, 2008, the board of directors of ABC makes a binding, irrevocable commitment to fund a minimum contribution of $10,000,000 to ABC's qualified retirement plan by March 14, 2009. ABC remits a $1,000,000 payment to the retirement plan on March 1, 2008, and a $9,000,000 payment on March 3, 2009. ABC does not incur any other related retirement plan deductions during its 2008 taxable year.

(ii) Under the rule provided in paragraph (f)(2)(i) of this section, ABC's employer deduction for payment made to the qualified plan must be allocated throughout the tax year for estimated tax purposes in a reasonably accurate manner. Therefore, ABC will not be permitted to allocate the $10,000,000 deduction to its first installment period. Under paragraph (f)(2)(iii) of this section, ABC's qualified plan deduction will be deemed to be allocated in a reasonably accurate manner if the item is allocated ratably throughout the taxable year. Therefore, ABC will be permitted to allocate $2,500,000 of its qualified plan deduction in its first installment period.

Example 6. Prepaid expense. (i) Corporation ABC, a calendar year taxpayer, uses an accrual method of accounting and does not capitalize qualifying costs under the exception provided for in §1.263(a)–4(f). ABC uses the annualized income installment method under section 6655(e)(2)(A)(i) to calculate all of its required installment payments for its 2008 taxable year. On July 1, 2008, ABC purchases an annual business license from State X which permits ABC to operate its business in State X from July 1, 2008, through June 30, 2009. An annual payment of $12,000 is due on July 1, 2008, and ABC pays the fee on this date. ABC has not elected out of the 12-month rule provided by §1.263(a)–4(f) and therefore ABC is not required to capitalize any amount paid for the license and will recognize a $12,000 deduction for the tax year ending December 31, 2008, with respect to this license.

(ii) Under the rule provided in paragraph (f)(2)(ii) of this section, ABC's $12,000 business license expense must be allocated in a reasonably accurate manner because ABC utilizes the 12-month rule exception provided for in the §1.263(a)–4(f). Under paragraph (f)(2)(iii) of this section, ABC's deduction will be deemed to be allocated in a reasonably accurate manner if the item is allocated ratably throughout the taxable year. Therefore, ABC will be permitted to allocate $3,000 of its business license deduction in its first installment period.

Example 7. Real property tax liability. (i) Corporation ABC, a calendar year taxpayer, uses an accrual method of accounting and the annualized income installment method under section 6655(e)(2)(A)(i) to calculate all of its required installment payments for its 2008 taxable year. ABC owns real property in State Y and uses the real property in its trade or business. ABC incurs a $400,000 deduction for State Y real estate taxes during ABC's December 31, 2008, taxable year. ABC has elected to recognize its real property taxes ratably under section 461(c).

(ii) Under the rule provided in paragraph (f)(2)(i) of this section, ABC's $400,000 real property tax liabilities must be allocated in a reasonably accurate manner. However, paragraph (f)(2)(iv) of this section provides that with respect to real property taxes for which an election has been made under section 461(c), ratable accrual is the only method which will be considered a reasonably accurate method. Therefore, ABC will be required to allocate its $400,000 real property taxes ratably for estimated tax purposes and thus $100,000 will be allocated to the ABC's first annualized income installment.

Example 8. NOL (Net Operating Loss) deduction. Corporation ABC, a calendar year taxpayer, uses an accrual method of accounting and the annualized income installment method under section 6655(e)(2)(A)(i) to calculate all of its required installment payments for its 2008 taxable year. ABC has a net operating loss carryover to 2008 of $2,000,000. ABC's taxable income from January 1, 2008, through March 31, 2008, without regard to any net operating loss deduction, is $1,500,000 (pre-NOL taxable income). Under the special rule for net operating loss deductions provided in paragraph (f)(3)(ii) of this section, the NOL deduction is treated as an extraordinary item incurred on the first day of ABC's December 31, 2008, tax year. Therefore, the NOL deduction is taken into account after annualization for purposes of determining ABC's first annualized income installment.

Example 9. Advance payment. (i) Corporation ABC, a calendar year taxpayer, uses an accrual method of accounting and the annualized income installment method under section 6655(e)(2)(A)(i) to calculate all of its required installment payments for its 2008 and 2009 taxable years. ABC is in the business of giving dancing lessons and receives advance payments. For Federal income tax purposes, ABC uses the Deferral Method provided in section 5.02 of Rev. Proc. 2004–34 for the advance payments it receives for dance lessons. On November 1, 2008, ABC receives an advance payment of $2,400 for a 2-year contract commencing on November 1, 2008, and providing for up to 24 individual, 1-hour lessons. ABC provides 2 lessons in 2008, 12 lessons in 2009, and 10 lessons in 2010. ABC recognizes $200 in revenues in its financial statements for the last quarter of 2008. ABC recognizes $300 in revenues in its financial statements for each quarter of 2009 for a total of $1,200 in 2009. ABC recognizes the remaining $1,000 in revenues in its financial statements during 2010. For tax purposes, ABC recognizes $200 into revenue in 2008 and $2,200 into revenue in 2009 under Rev. Proc. 2004–34. See §601.601(d)(2)(ii)(*b*).

(ii) Pursuant to paragraph (f)(3)(i)(B) of this section, ABC is not required to take into account any of the advance payment for purposes of computing any required installment payment for ABC's 2008 taxable year because no part of the $2,400 advance payment was recognized as income in ABC's financial statements during the first nine months of ABC's 2008 taxable year. In 2009, ABC must take into account $300 of revenue for purposes of computing its first and second required installment payments, $600 of revenue for purposes of computing its third required installment payment and $900 for purposes of computing its fourth required installment payment. Pursuant to paragraph (f)(3)(i)(B) of this section, the remaining deferred revenue is recognized on December 31, 2009, for purposes of computing ABC's annualized income installments for 2009.

Example 10. Section 481(a) adjustment. Corporation ABC, a calendar year taxpayer, uses an accrual method of accounting and the annualized income installment method under section 6655(e)(2)(A)(i) to calculate all of its required installment payments for its 2008 taxable year. On December 20, 2008, ABC files a Form 3115 requesting permission to change its method of accounting. The requested change results in a negative section 481(a) adjustment of $80,000. ABC subsequently receives the consent of the Commissioner to make the change and therefore, the negative $80,000 section 481(a) adjustment is properly recognized in ABC's tax return for the year ending December 31, 2008. Under paragraph (f)(3)(ii) of this section ABC is permitted to recognize the negative $80,000 section 481(a) adjustment as an extraordinary item occurring on January 1, 2008 (the first day of ABC's December 31, 2008, tax year), or December 20, 2008 (the date ABC filed the Form 3115). ABC chooses to recognize the negative $80,000 section 481(a) adjustment as an extraordinary item occurring in January 1, 2008. Accordingly, $80,000 of the negative section 481(a) adjustment is taken into account after annualization for purposes of determining ABC's first annualized income installment. In addition, under §1.6655–6(b), ABC is required to use its new method of accounting as of January 1, 2008 for estimated tax purposes, consistent with the recognition of the section 481(a) adjustment for estimated tax purposes. Therefore, ABC will be required to use the new method of accounting in determining taxable income to be annualized in computing ABC's first annualized income installment.

Example 11. Section 481(a) adjustment. Corporation ABC, a calendar year taxpayer, uses an accrual method of accounting and uses the annualized income installment method under section 6655(e)(2)(A)(i) to calculate all of its required installment payments for its 2008 taxable year. On June 15, 2008, ABC files a Form 3115 requesting permission to change its method of accounting. The requested change results in a positive section 481(a) adjustment of $240,000. ABC subsequently receives the consent of the Commissioner to make the change and therefore, $60,000 of the section 481(a) adjustment (one quarter of the positive $240,000 section 481(a) adjustment) is properly recognized in ABC's tax return for the year ending December 31, 2008. Under paragraph (f)(3)(ii) of this section, ABC is permitted to recognize the positive $60,000 section 481(a) adjustment as an extraordinary item occurring on January 1, 2008 (the first day of ABC's December 31, 2008, tax year), or June 15, 2008 (the date ABC filed the Form 3115). ABC chooses to recognize the positive $60,000 section 481(a) adjustment as an extraordinary item occurring on June 15, 2008. Accordingly, the $60,000 positive section 481(a) adjustment is not taken into account for purposes of determining ABC's first annualized income installment. However, in all futures years any portion of the section 481(a) adjustment related to this change in method of accounting will be treated as an extraordinary item occurring on the first day of the tax year under paragraph (f)(3)(ii) of this section. In addition, under §1.6655–6(b), ABC is required to use its new method of accounting as of June 15, 2008 for estimated tax purposes, consistent with the recognition of the section 481(a) adjustment for estimated tax purposes. Therefore, ABC will be required to use the new method of accounting (as of the beginning of the tax year) for purposes of determining taxable income to be annualized in computing ABC's third and fourth annualized income installments (which are based upon annualization periods that include June 15, 2008.)

Example 12. Extraordinary item. Corporation ABC, a calendar year taxpayer, uses an accrual method of accounting and the annualized income installment method under section 6655(e)(2)(A)(i) to calculate all of its required installment payments for its 2008 taxable year. On May 10, 2008, ABC reaches a settlement agreement with XYZ over a tort action filed by ABC. As a result, ABC receives a payment of $10,000,000 on June 15, 2006, that is recognized as income by ABC. The settlement of a tort action is an extraordinary item defined in paragraph (f)(3)(ii)(A) of this section. Accordingly, the $10,000,000 of income will be taken into account by ABC on May 10, 2008, for purposes of computing ABC's annualized income installments for 2008. Therefore, the $10,000,000 settlement will only be taken into account in computing ABC's third and fourth annualized income installments (which are based upon annualization periods that include May 10, 2008). In addition, the $10,000,000 settlement income will be taken into account as an extraordinary item of income after annualization for purposes of determining ABC's third and fourth annualized installment payments.

Example 13. Credit carryover. Corporation ABC, a calendar year taxpayer, uses an accrual method of accounting and the annualized income installment method under section 6655(e)(2)(A)(i) to calculate all of its required installment payments for its 2008 taxable year. ABC projects its annualized tax for its 2008 taxable year, based on annualizing ABC's taxable income for its first annualization period from January 1, 2008, through March 31, 2008, to be $1,500,000 before reduction for any credits. ABC has an unused section 38 credit from 2007 for increasing research activities from 2007 of $500,000 that is carried over to 2008. For purposes of determining ABC's first annualized income installment, ABC's annualized tax for 2008 is $1,000,000, determined as the tax for the taxable year computed by placing on an annualized basis ABC's taxable income from its first annualization period from January 1, 2008, through March 31, 2008 ($1,500,000) reduced by the $500,000 credit carryover from 2007. Therefore, ABC's first required installment payment for 2008 is $250,000 ($1,000,000 × 25%).

Example 14. Current year credit. Corporation ABC, a calendar year taxpayer, uses an accrual method of accounting and the annualized income installment method under section 6655(e)(2)(A)(i) to calculate all of its required installment payments for its 2008 taxable year. ABC projects its annualized tax for its 2008 taxable year, based on annualizing ABC's taxable income for its first annualization period from January 1, 2008, through March 31, 2008, to be $2,000,000 before reduction for any credits. ABC has historically earned a section 41 credit for increasing research activities and, for 2008, ABC estimates that it will earn a credit for increasing research activities under section 41 of $1,200,000. However, pursuant to paragraph (f)(3)(iii) of this section, if ABC were to annualize all components involved in computing the current year credit based on ABC's activity from January 1, 2008, through March 31, 2008, ABC would generate a credit of $1,600,000 for 2008. For purposes of determining ABC's first annualized income installment, ABC's annualized tax for 2008 is $400,000, determined as the tax for the 2008 taxable year ($2,000,000) computed by placing on an annualized basis ABC's taxable income from its first annualization period January 1, 2008, through March 31, 2008, reduced by a $1,600,000 current year section 41 credit from increasing research activities. Therefore, ABC's first required installment payment for 2008 is $100,000 ($400,000 × 25%).

Example 15. Current year credit. Same facts as *Example 14* except that ABC does not begin any research activities until April 3, 2008, and will not incur any research expenses described in paragraph (f)(1)(ii) of this section. As a result, if ABC were to annualize all components involved in computing the current year credit based on ABC's activity from January 1, 2008, through March 31, 2008, ABC would generate no section 41 research credit for purposes of determining its first annualized income installment. Pursuant to paragraph (f)(3)(iii) of this section, ABC cannot take into account any credit for its first annualization period because ABC did not incur any qualified research expenses by the last day of the first annualization period. Accordingly, for purposes of determining ABC's first annualized income installment, ABC's annualized tax for its first annualization period January 1, 2008, through March 31, 2008, is $2,000,000. Therefore, ABC's first required installment payment for 2008 is $500,000 ($2,000,000 × 25%).

Example 16. Depreciation and amortization expense. Corporation ABC, a calendar year taxpayer that began business on January 2, 2007, adopted an accrual method of accounting and will use the annualized income installment method under section 6655(e)(2)(A)(i) to calculate all of its required installment payments for its 2008 taxable year. On January 2, 2007, ABC purchased and placed in service a tangible depreciable asset that costs $50,000 and is 5-year property under section 168(e). ABC depreciates its 5-year property placed in service in 2007 under the general depreciation system using the 200-percent declining balance method, a 5-year recovery period, and the half year convention. On January 2, 2008, ABC purchased and placed in service qualified Gulf Opportunity Zone property (GO Zone property) that costs $30,000 and is 5-year property under section 168(e). ABC will depreciate its 5-year property placed in service in 2008 under the general depreciation system using the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. ABC will deduct the 50% additional first year depreciation deduction under section 1400N(d) with respect to the GO Zone property. For tax year 2007, ABC takes a depreciation deduction under section 168 of $10,000 ($50,000 × 20% = $10,000). ABC does not anticipate being subject to the mid-quarter convention for the 2008 taxable year, does not anticipate making any depreciation elections for any class of property, does not anticipate making a section 179 election, does not anticipate any sales or other dispositions of depreciable property, and no events have occurred, nor does ABC know, based on all relevant information available as of the due date of ABC's first required installment for 2008, of any event that will occur to cause ABC's 2008 taxable year to be a short taxable year. The optional amounts of depreciation expense ABC may take into account for its first annualized income installment for its 2008 taxable year are determined as follows:

(i) *General rule—Estimated annual depreciation.* In accordance with the general rule provided in paragraph (f)(3)(iv)(A) of this section, ABC may take a depreciation expense of $8,500 ($34,000 × 3⁄12 = $8,500) into account in computing ABC's January 1, 2008, through March 31, 2008, taxable income. ABC's estimated annual depreciation expense for 2008 of $34,000 is computed as follows: $15,000 for the 50% additional first year depreciation deduction under section 1400N(d) ($30,000 × 50% = $15,000) plus annual depreciation of $16,000 ($40,000 × 40% = $16,000) and $3,000 ($15,000 × 20% = $3,000). Under paragraphs (c)(3) and (f)(3)(iv)(C) of this section, ABC may not consider its first annualization period to be a short taxable year for purposes of determining the depreciation allowance for such annualization period.

(ii) *Safe Harbor—Proportionate depreciation allowance.* In accordance with the safe harbor provided in paragraph (f)(3)(iv)(B)(*1*) of this section, ABC may take a depreciation expense of $8,500 ($34,000 × 3/12 = $8,500) into account in computing ABC's January 1, 2008, through March 31, 2008, taxable income based on annual depreciation expense for 2008 of $34,000, computed as follows: $15,000 for the 50% additional first year depreciation deduction under section 1400N(d) ($30,000 × 50% = $15,000) plus annual depreciation of $16,000 ($40,000 × 40% = $16,000) and $3,000 ($15,000 × 20% = $3,000). Under paragraphs (c)(3) and (f)(3)(iv)(C) of this section, ABC may not consider its first annualization period to be a short taxable year for purposes of determining the depreciation allowance for such annualization period.

(iii) *Safe Harbor—90 percent of preceding year's depreciation.* In accordance with the safe harbor in paragraph (f)(3)(iv)(B)(*2*) of this section, ABC may take a depreciation expense of $2,250 ($10,000 prior year's depreciation × 90% = $9,000 × 3/12 = $2,250) into account in computing ABC's January 1, 2008, through March 31, 2008, taxable income. Under paragraphs (c)(3) and (f)(3)(iv)(C) of this section, ABC may not consider its first annualization period to be a short taxable year for purposes of determining the depreciation allowance for such annualization period.

(g) *Items that substantially affect taxable income but cannot be determined accurately by the installment due date*—(1) *In general.* In determining the applicability of the annualization exceptions described in paragraphs (a) and (b) of this section and § 1.6655–3, reasonable estimates may be made from existing data for items that substantially affect income if the amount of such items cannot be determined accurately by the installment due date. This paragraph (g) applies only to the inflation index for taxpayers using the dollar-value LIFO (last-in, first-out) inventory method, adjustments required under section 263A, the computation of a taxpayer's section 199 deduction, intercompany adjustments for taxpayers that file consolidated returns, the liquidation of a LIFO layer at the installment date that the taxpayer reasonably believes will be replaced at the end of the year, deferred gain on a qualifying conversion or exchange of property under sections 1031 and 1033 that the taxpayer reasonably believes will be replaced with qualifying replacement property, and any other item designated by the Secretary by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter).

(2) *Example.* The following example illustrates the rules of this paragraph (g):

Example. Section 199 deduction. Corporation ABC, a calendar year taxpayer, uses an accrual method of accounting and the annualized income installment method under section 6655(e)(2)(A)(i) to calculate all of its required installment payments for its 2008 taxable year. ABC engages in production activities that generate qualified production activities income (QPAI), as defined in § 1.199–1(c), and projects taxable income of $50,000 for its first annualization period from January 1, 2008, through March 31, 2008, without taking into account the section 199 deduction. During its first annualization period from January 1, 2008, through March 31, 2008, ABC incurs W–2 wages allocable to domestic production gross receipts pursuant to section 199(b)(2) of $10,000. Pursuant to paragraph (g)(1) of this section, ABC is permitted to take into account its estimated section 199 deduction before annualizing taxable income based on the lesser of its estimated QPAI or taxable income and W–2 wages for its first installment period for 2008. For the first installment period in 2008, ABC is permitted to recognize a deduction under section 199 of $3,000 ($50,000 × .06 = $3,000) subject to the wage limitation of $5,000 (50 percent of $10,000 of W–2 wages incurred during the first installment period). Accordingly, ABC's annualized income for the first installment for 2008 is $188,000 (($50,000–$3,000) × 1⅔ = $188,000). The tax on $188,000 is $56,570 and ABC's first required installment for 2008 is $14,143 ($56,570 × .25 = $14,143).

(h) *Effective/applicability date.* This section applies to taxable years beginning after September 6, 2007.

[T.D. 9347, 72 FR 44349, Aug. 7, 2007; 72 FR 53684, Sept. 20, 2007; 72 FR 54350, Sept. 25, 2007]

§ 1.6655–2T Safe harbor for certain installments of tax due before July 1, 1987 (temporary).

(a) *Applicability*—(1) *Safe harbor.* The safe harbor provided by paragraph (b) of this section applies only to installment payments of corporate estimated tax required to be made before July 1, 1987, for taxable years beginning in 1987.

(2) *Subsequent payment.* The requirement that a corporation using the safe harbor provided by this section make a

timely subsequent installment payment in accordance with paragraph (c) of this section applies with respect to the corporation's first installment payment (''the subsequent installment payment'') of estimated tax required to be made after the last payment computed under the safe harbor rule.

(3) *Section inapplicable to new corporation.* This section shall not apply in the case of any corporation whose first taxable year began after December 31, 1986.

(b) *Safe harbor for use of annualization exception*—(1) *In general.* A corporation computing an installment payment of estimated tax using the annualization exception provided in section 6655(d)(3) will not be subject to an addition to tax under section 6655 with respect to an installment payment of estimated tax that satisfies the requirements of this paragraph (b), except as provided in paragraph (c) of this section. For purposes of this paragraph (b)—

(i) A corporation shall assume that its annualized taxable income for the current year equals or exceeds 120 percent of the taxable income shown on its return for the preceding taxable year, and

(ii) The term ''tax'' as used in section 6655(d)(3) shall be defined by reference to section 6655(f) without regard to section 6655(f)(1) (B) and (C) (that is, without regard to the alternative minimum tax imposed by section 55 or the environmental tax imposed by section 59A).

(2) *Special rules for determining taxable income for preceding year.* For purposes of paragraph (b)(1)(i) of this section, the taxable income shown on the return of the corporation for its preceding taxable year shall be—

(i) Adjusted to eliminate any net operating loss deduction taken into account in that preceding year, and

(ii) Annualized, if that preceding year was of less than 12 months.

(3) *Credits taken into account*—(i) *In general.* In computing the amount of an installment payment under paragraph (b)(1) of this section, the corporation may take into account any credits against tax that are permitted to be taken into account under section 6655(d)(3) for the current taxable year.

(ii) *Foreign tax credit.* For purposes of paragraph (b)(3)(i) of this section, the amount of foreign tax credit that is permitted to be taken into account for the current taxable year is equal to the foreign tax credit allowed for the preceding taxable year multiplied by the fraction specified in the following sentence. The numerator of the fraction is the highest tax rate applicable for the taxable year under section 11, as adjusted under section 15, and the denominator is 46 percent. This alternative computation of the foreign tax credit is applicable only for purposes of computing a safe harbor installment payment under paragraph (b) of this section and cannot be applied for other estimated tax purposes.

(4) *Net operating loss carryover.* A corporation that has a net operating loss carryover as of the first day of the taxable year for which the estimated tax is being paid may use that carryover to reduce the annualized taxable income referred to in paragraph (b)(1)(i) of this section. For example, if a corporation with a net operating loss carryover of \$3,000 had taxable income of \$10,000 in 1986, it may use the carryover to reduce its annualized taxable income to \$9,000, ((\$10,000 × 120%) − 3,000).

(c) *Corporation must bring aggregate payments to required level through timely subsequent installment*—(1) *In general.* A corporation using the safe harbor provided by paragraph (b) of this section shall make a timely subsequent installment payment of estimated tax in an amount sufficient to satisfy the requirements of either paragraph (c)(3) or paragraph (c)(4) of this section.

(2) *Applicable percentage.* For purposes of this paragraph (c), the applicable percentage is—

(i) 45 percent (50 percent × 90 percent), if the subsequent installment payment is the second installment payment for the taxable year, or

(ii) 67.5 percent (75 percent × 90 percent), if the subsequent installment payment is the third installment payment for the taxable year.

(3) *Annualization exception.* The subsequent installment payment of a corporation satisfies the requirements of this paragraph (c)(3) if the amount of the payment is sufficient to satisfy the requirements of section 6655(d)(3) with respect to all applicable taxes specified in section 6655(f). Thus, the corporation

must determine its annualized taxable income under section 6655(d)(3)(A) (ii) or (iii), whichever is applicable, and compute the resulting tax. The resulting tax shall include the alternative minimum tax under section 55 and the environmental tax under section 59A and may take credits into account to the extent permitted under section 6655(d)(3). The sum of this subsequent installment payment and the earlier installment payment or payments of the corporation must equal or exceed the applicable percentage of the tax so computed. In determining whether the corporation has satisfied the requirements of section 6655(d)(3)(A) (ii) or (iii) with respect to the subsequent installment, the safe harbor provided in paragraph (b)(1) of this section shall not apply.

(4) *Installment payments equal to applicable percentage of tax shown on return.* The subsequent installment payment of a corporation satisfies the requirement of this paragraph (c)(4) if the sum of that payment and the earlier installment payment or payments of the corporation equals or exceeds the applicable percentage of the tax shown on the return of the corporation for the taxable year to which the installment payments relate. The tax shown on the return includes all taxes specified in section 6655(f).

(5) *Consequence of corporation's failure to satisfy requirements for subsequent installment*—(i) *In general.* If a corporation fails to satisfy the requirements set out in this paragraph (c), the corporation shall lose the benefit of the safe harbor provided by paragraph (b)(1) of this section.

(ii) *Limit on penalty.* The aggregate underpayment penalty with respect to any installment payment or payments for which a corporation loses the benefit of the safe harbor under paragraph (c)(5)(i) of this section shall be limited to the ''shortfall penalty amount.'' The shortfall penalty amount is the penalty that would be imposed under section 6655(a) if there were an underpayment of the subsequent installment payment equal to the excess of—

(A) The amount required to be paid, as determined under this paragraph (c), on or before the due date of the subsequent installment payment, over

(B) The amount actually paid on or before such date with respect to the subsequent installment payment.

For purposes of this determination, the period of the underpayment shall run from the due date of the subsequent installment payment until the earlier of the dates specified in section 6655(c) (1) or (2).

(iii) *Example.* The provisions of this paragraph (c)(5) may be illustrated by the following example:

Example. Corporation M, which uses the calendar year as its taxable year, relies on the safe harbor provided by paragraph (b) of this section for its first two installment payments of estimated tax for 1987. M is required by this paragraph (c) to make a timely subsequent installment payment of $1,000,000 by September 15, 1987, but M's actual installment payment by that date is only $990,000. Because of this shortfall, M loses the benefit of the safe harbor and is subject to underpayment penalties with respect to the first two installments. The aggregate penalties with respect to those two installments, however, cannot exceed the amount of the underpayment penalty to which M would be subject if there were an underpayment of $10,000 with respect to the September 15, 1987, installment payment. Such penalties are independent of any penalty that may apply with respect to M's third installment payment under the normal rules of section 6655.

(d) *Example.* The provisions of this section may be illustrated by the following example:

Example. (i) Corporation X (which is not a life insurance company) uses as its taxable year a fiscal year ending on January 31 and is required to pay an installment of estimated income tax by May 15, 1987, for its taxable year beginning on February 1, 1987. On its return for the taxable year ending January 31, 1987, which was a year of 12 months, X reported taxable income of $10,000,000 ($9,000,000 of which was ordinary income and $1,000,000 of which was net capital gain) and did not claim any net operating loss deduction. As of February 1, 1987, X has no net operating loss carryforwards and no credit carryforwards. X has no credits against tax that are permitted to be taken into account under section 6655(d)(3) for 1987. If X uses the safe harbor provided in paragraph (b)(1) of this section, X must make by May 15, 1987, an installment payment of estimated tax of at least $1,037,836, computed as follows:

(1) Taxable income shown on return for taxable year ending on January 31, 1987	$10,000,000
(2) Annualized taxable income for taxable year ending January 31, 1988, determined pursuant to paragraph (b)(1) of this section (Item (1)x120%)	$12,000,000

(Note: 120%xordinary income of $9,000,000=$10,800,000; 120%xnet capital gain of $1,000,000=$1,200,000)

(3) Tax on annualized taxable income (Item 2) using rates under section 11 and 1201, taking into account section 15, applicable to the taxable year ending January 31, 1988	$4,612,603
(4) Amount described in section 6655(d)(3)(A)(i) (Item (3)x22.5%)	$1,037,836

(ii) To preclude imposition of an addition to tax under section 6655 with respect to its May 15, 1987, installment payment, X must make by July 15, 1987, a second installment payment of estimated tax sufficient to bring its aggregate payments to the minimum level required under paragraph (c) of this section.

(iii) X may satisfy the requirements of paragraph (c)(3) of this section by making a second installment payment sufficient to bring X within the exception provided in section 6655(d)(3). Thus, if X determines under that section that the aggregate of X's installment payments of estimated tax by July 15, 1987, must equal at least $3,000,000, X may obtain the benefit of the safe harbor provided in paragraph (b)(1) of this section with respect to the May 15, 1987, installment payment by making a timely second installment payment of $1,962,164 ($3,000,000—$1,037,836).

(iv) Even if X fails to satisfy the requirements of paragraph (c)(3) of this section, X may obtain the benefit of the safe harbor for the May 15, 1987, installment payment if X's second installment payment, when aggregated with the first payment, equals at least 45 percent of the tax (including the alternative minimum tax under section 55 and the environmental tax under section 59A) shown on X's return for X's taxable year beginning on February 1, 1987. Thus, if the tax shown on that return is $6,000,000, X's second installment payment under paragraph (c)(4) of this section must be at least $1,662,164, computed as follows:

45 percent of $6,000,000	$2,700,000
less first payment	1,037,836
Minimum second installment	$1,662,164

[T.D. 8132, 52 FR 10051, Mar. 30, 1987]

§ 1.6655–3 Adjusted seasonal installment method.

(a) *In general.* In the case of any required installment, the amount of the adjusted seasonal installment is the excess (if any) of—

(1) 100 percent of the amount determined under paragraph (c) of this section; over

(2) The aggregate amount of all prior required installments for the taxable year.

(b) *Limitation on application of section.* This section applies only if the base period percentage (as defined in section 6655(e)(3)(D)(i) and paragraph (d)(1) of this section) for any six consecutive months of the taxable year equals or exceeds seventy percent.

(c) *Determination of amount.* The amount determined under this paragraph (c) for any installment will be determined in the following manner—

(1) Take the taxable income for all months during the taxable year preceding the filing month;

(2) Divide such amount by the base period percentage for all months during the taxable year preceding the filing month;

(3) Determine the tax on the amount determined under paragraph (c)(2) of this section; and

(4) Multiply the tax computed under paragraph (c)(3) of this section by the base period percentage for the filing month and all months during the taxable year preceding the filing month.

(d) *Special rules*—(1) *Base period percentage.* The base period percentage for any period of months is the average percent that the taxable income for the corresponding months in each of the three preceding taxable years bears to the taxable income for the three preceding taxable years. If there is no taxable income for the corresponding months, taxable income for this purpose is zero.

(2) *Filing month.* The term *filing month* means the month in which the installment is required to be paid.

(3) *Application of the rules related to the annualized income installment method to the adjusted seasonal installment method.* The rules governing the computation of taxable income (and resulting tax) for purposes of determining any

required installment payment of estimated tax under the annualized income installment method under § 1.6655–2 apply to the computation of taxable income (and resulting tax) for purposes of determining any required installment payment of estimated tax under the adjusted seasonal installment method.

(4) *Alternative minimum tax*. The amount determined under paragraph (c) of this section must properly take into account the amount of any alternative minimum tax under section 55 that would apply for the period of the computation. The amount of any alternative minimum tax that would apply is determined by applying to alternative minimum taxable income, tentative minimum tax, and alternative minimum tax, the rules described in paragraph (c) of this section for taxable income and tax.

(e) *Example*. The provisions of this section may be illustrated by the following example:

Example. (i) X, a corporation that reports on a calendar year basis, expects to have an estimated tax liability of $1,200,000 for its taxable year ending December 31, 2009. On its 2008 tax return, X reports a tax liability of $652,800. X pays four installments of estimated tax, each in the amount of $250,000, $250,000, $250,000, and $450,000 on April 15, 2009, June 15, 2009, September 15, 2009, and December 15, 2009, respectively. X reports a tax liability of $1,152,600 on its return due March 15, 2010, with no credits against tax. Under the general provision of section 6655(b) and section 6655(d), there was an underpayment in the amount of $76,300 for the second installment through September 15, 2009, and $114,450 for the third installment through December 15, 2009, determined as follows:

(A) Tax as defined in section 6655(g) = $1,152,600

(B) 100% of this paragraph (e), Example (i)(A) = $1,152,600

(C) Amount of estimated tax required to be paid on or before the first installment (25% of $652,800) = $163,200

(D) Deduction of amount timely paid on or before the first installment due date under the general rule of section 6655(b) = $250,000

(E) Amount of overpaid estimated tax for the first installment date = $86,800

(F) Amount of estimated tax required to be paid on or before the second installment (25% of $1,152,600 plus the recapture amount under section 6655(d)(2)(B) of $124,950 (25% of $1,152,600 less $163,200)) = $413,100

(G) Deduction of amount paid on or before the due date of the second installment less amount applied towards the first installment under the general rule of section 6655(b) ($250,000 paid in each of the first and second installments less this paragraph (e), Example (i)(C)) = $336,800

(H) Amount of underpayment for the second installment date = $76,300

(I) Amount of estimated tax required to be paid on or before the third installment (25% of $1,152,600) = $288,150

(J) Deduction of amount paid on or before the due date of the third installment less amount applied towards the first and second installments under the general rule of section 6655(b) ($250,000 paid in each of the first, second, and third installments less this paragraph (e), *Example* (i)(C) less this paragraph (e), *Example* (i)(F)) = $173,700

(K) Amount of underpayment for the third installment date = $114,450

(L) Amount of estimated tax required to be paid on or before the fourth installment (25% of $1,152,600) = $288,150

(M) Deduction of amount paid on or before the due date of the fourth installment less amount applied towards the first, second, and third installments under the general rule of section 6655(b) ($250,000 paid in each of the first, second, and third installments plus $450,000 paid in the fourth installment less this paragraph (e), *Example* (i)(C) less this paragraph (e), *Example* (i)(F) less this paragraph (e), *Example* (i)(I)) = $335,550

(N) Amount of overpaid estimated tax for the fourth installment date = $47,400

(ii) X wants to determine if it qualifies for the adjusted seasonal installment method. X determines that its monthly taxable income for the preceding three taxable years and for the current taxable year 2009 is as follows:

January	February	March	April	May	June	July	August	September	October	November	December
2006: $100,000	$90,000	$80,000	$70,000	$60,000	$20,000	$10,000	$10,000	$10,000	$10,000	$10,000	$10,000
2007: 200,000	170,000	170,000	130,000	125,000	45,000	21,000	19,000	20,000	20,000	20,000	20,000
2008: 410,000	350,000	330,000	270,000	240,000	80,000	40,000	40,000	40,000	40,000	40,000	40,000
2009: 600,000	680,000	650,000	560,000	460,000	170,000	70,000	60,000	50,000	40,000	30,000	20,000

(iii) X must initially determine if its base period percentage for the same 6 consecutive months of the 3 preceding taxable years equals or exceeds 70 percent (see section 6655(e)(3) and paragraphs (b) and (c) of this section). By using its taxable income for the first 6 months of 2006, 2007, and 2008, X qualifies for the adjusted seasonal installment method because its base period percentage is 87.5 percent (which exceeds 70 percent) computed as follows:

(A) Taxable income for first 6 months of 2006 = $420,000

(B) Total taxable income for 2006 = $480,000

(C) Divide this paragraph (e), *Example* (iii)(A) by this paragraph (e), *Example* (iii)(B) = .875

(D) Taxable income for first 6 months of 2007 = $840,000

(E) Total taxable income for 2007 = $960,000

(F) Divide this paragraph (e), *Example* (iii)(D) by this paragraph (e), *Example* (iii)(E) = .875

(G) Taxable income for first 6 months of 2008 = $1,680,000

(H) Total taxable income for 2008 = $1,920,000

(I) Divide this paragraph (e), *Example* (iii)(G) by this paragraph (e), *Example* (iii)(H) = .875

(J) Add this paragraph (e), *Example* (iii)(C), (F), and (I) = $2.625

(K) Divide this paragraph (e), *Example* (iii)(J) by 3 = .875

(iv) To determine the amount of the first installment under the rules of section 6655(e)(3) and paragraph (a) of this section, the following computation is necessary:

(A) Taxable income for first 3 months of 2009 = $1,930,000

(B) Taxable income for first 3 months of 2006 ($270,000) divided by total taxable income for 2006 ($480,000) = .5625

(C) Taxable income for first 3 months of 2007 ($540,000) divided by total taxable income for 2007 ($960,000) = .5625

(D) Taxable income for first 3 months of 2008 ($1,090,000) divided by total taxable income for 2008 ($1,920,000) = .5677

(E) Add this paragraph (e), *Example* (iv)(B), (C), and (D) and divide by 3 = .5642

(F) Divide this paragraph (e), *Example* (iv)(A) by this paragraph (e), *Example* (iv)(E) = $3,420,773

(G) Determine the tax on this paragraph (e), *Example* (iv)(F) = $1,163,049

(H) Taxable income for first 4 months of 2006 ($340,000) divided by total taxable income for 2006 ($480,000) = .7083

(I) Taxable income for first 4 months of 2007 ($670,000) divided by total taxable income for 2007 ($960,000) = .6979

(J) Taxable income for first 4 months of 2008 ($1,360,000) divided by total taxable income for 2008 (1,920,000) = .7083

(K) Add this paragraph (e), *Example* (iv)(H), (I), and (J) and divide by 3 = .7048

(L) Multiply this paragraph (e), *Example* (iv)(G) by this paragraph (e), *Example* (iv)(K) = $819,717

(M) 100% of this paragraph (e), *Example* (iv)(L) = $819,717

(N) Amount of all prior required installments for 2009 = $0

(O) Amount of adjusted seasonal installment for the first installment payment (this paragraph (e), *Example* (iv)(M) less this paragraph (e), *Example* (iv)(N)) = $819,717

(v) To determine the amount of the second installment under the rules of section 6655(e)(3) and paragraph (a) of this section, the following computation is necessary:

(A) Taxable income for first 5 months of 2009 = $2,950,000

(B) Taxable income for first 5 months of 2006 ($400,000) divided by total taxable income for 2006 ($480,000) = .8333

(C) Taxable income for first 5 months of 2007 ($795,000) divided by total taxable income for 2007 ($960,000) = .8281

(D) Taxable income for first 5 months of 2008 ($1,600,000) divided by total taxable income for 2008 ($1,920,000) = .8333

(E) Add this paragraph (e), *Example* (v)(B), (C), and (D) and divide by 3 = .8316

(F) Divide this paragraph (e), *Example* (v)(A) by this paragraph (e), *Example* (v)(E) = $3,547,379

(G) Determine the tax on this paragraph (e), *Example* (v)(F) = $1,206,109

(H) Taxable income for first 6 months of 2006 ($420,000) divided by total taxable income for 2006 ($480,000) = .875

(I) Taxable income for first 6 months of 2007 ($840,000) divided by total taxable income for 2007 ($960,000) = .875

(J) Taxable income for first 6 months of 2008 ($1,680,000) divided by total taxable income for 2008 ($1,920,000) = .875

(K) Add this paragraph (e), *Example* (v)(H), (I), and (J) and divide by 3 = .875

(L) Multiply this paragraph (e), *Example* (v)(G) by this paragraph (e), *Example* (v)(K) = $1,055,345

(M) 100% of this paragraph (e), *Example* (v)(L) = $1,055,345

(N) Amount of all prior required installments for 2009 = $163,200

(O) Amount of adjusted seasonal installment for the second installment payment (this paragraph (e), *Example* (v)(M) less this paragraph (e), *Example* (v)(N)) = $892,145

(vi) To determine the amount of the third installment under the rules of section 6655(e)(3) and paragraph (a) of this section, the following computation is necessary:

(A) Taxable income for first 8 months of 2009 = $3,250,000

(B) Taxable income for first 8 months of 2006 ($440,000) divided by total taxable income for 2006 ($480,000) = .9167

(C) Taxable income for first 8 months of 2007 ($880,000) divided by total taxable income for 2007 ($960,000) = .9167

(D) Taxable income for first 8 months of 2008 ($1,760,000) divided by total taxable income for 2008 ($1,920,000) = .9167

(E) Add this paragraph (e), *Example* (vi)(B), (C), and (D) and divide by 3 = .9167

(F) Divide this paragraph (e), *Example* (vi)(A) by this paragraph (e), *Example* (vi)(E) = $3,545,326

(G) Determine the tax on this paragraph (e), *Example* (vi)(F) = $1,205,411

(H) Taxable income for first 9 months of 2006 ($450,000) divided by total taxable income for 2006 ($480,000) = .9375

(I) Taxable income for first 9 months of 2007 ($900,000) divided by total taxable income for 2007 ($960,000) = .9375

(J) Taxable income for first 9 months of 2008 ($1,800,000) divided by total taxable income for 2008 ($1,920,000) = .9375

(K) Add this paragraph (e), *Example* (vi)(H), (I), and (J) and divide by 3 = .9375

(L) Multiply this paragraph (e), *Example* (vi)(G) by this paragraph (e), *Example* (vi)(K) = $1,130,073

(M) 100% of this paragraph (e), *Example* (vi)(L) = $1,130,073

(N) Amount of all prior required installments for 2009 = $576,300

(O) Amount of adjusted seasonal installment for the third installment payment (this paragraph (e), *Example* (vi)(M) less this paragraph (e), *Example* (vi)(N)) = $553,773

(vii) To determine the amount of the fourth installment under the rules of section 6655(e)(3) and paragraph (a) of this section, the following computation is necessary:

(A) Taxable income for first 11 months of 2009 = $3,370,000

(B) Taxable income for first 11 months of 2006 ($470,000) divided by total taxable income for 2006 ($480,000) = .9792

(C) Taxable income for first 11 months of 2007 ($940,000) divided by total taxable income for 2007 ($960,000) = .9792

(D) Taxable income for first 11 months of 2008 ($1,880,000) divided by total taxable income for 2008 ($1,920,000) = .9792

(E) Add this paragraph (e), *Example* (vii)(B), (C), and (D) and divide by 3 = .9792

(F) Divide this paragraph (e), *Example* (vii)(A) by this paragraph (e), *Example* (vii)(E) = $3,441,585

(G) Determine the tax on this paragraph (e), *Example* (vii)(F) = $1,170,139

(H) Taxable income for first 12 months of 2006 ($480,000) divided by total taxable income for 2006 ($480,000) = 1.0000

(I) Taxable income for first 12 months of 2007 ($960,000) divided by total taxable income for 2007 ($960,000) = 1.0000

(J) Taxable income for first 12 months of 2008 ($1,920,000) divided by total taxable income for 2008 ($1,920,000) = 1.0000

(K) Add this paragraph (e), *Example* (vii)(H), (I), and (J) and divide by 3 = 1.0000

(L) Multiply this paragraph (e), *Example* (vii)(G) by this paragraph (e), *Example* (vi)(K) = $1,170,139

(M) 100% of this paragraph (e), *Example* (vii)(L) = $1,170,139

(N) Amount of all prior required installments for 2009 = $864,450

(O) Amount of adjusted seasonal installment for the fourth installment payment (this paragraph (e), *Example* (vii)(M) less this paragraph (e), *Example* (vii)(N)) = $305,689

(viii) Because the total amount of each required estimated tax payment determined under section 6655(e)(3) and paragraph (a) of this section exceeds the amount of each required estimated tax payment determined under section 6655(d) and §1.6655–1(d) and (e), the exception described in section 6655(e) and this section does not apply and the addition to the tax with respect to the underpayment for the June 15, 2009, and September 15, 2009, installments will be imposed unless another exception (for example, see section 6655(e)(2)) applies with respect to these installments.

(f) *Effective/applicability date.* This section applies to taxable years beginning after September 6, 2007.

[T.D. 9347, 72 FR 44358, Aug. 7, 2007]

§ 1.6655–4 Large corporations.

(a) *Large corporation defined.* The term *large corporation* means any corporation (or a predecessor corporation) that had taxable income of at least $1,000,000 for any taxable year during the testing period. For purposes of this section, a predecessor corporation is the distributor or transferor corporation in a transaction to which section 381 (relating to carryovers in certain corporate acquisitions) applies.

(b) *Testing period.* For purposes of paragraph (a) of this section, the term *testing period* means the 3 taxable years immediately preceding the taxable year for which estimated tax is being determined (the current taxable year) or, if less, the number of taxable years the taxpayer has been in existence.

(c) *Computation of taxable income during testing period*—(1) *Short taxable year.* In the case of a corporation (or predecessor corporation) that had a short taxable year during the testing period, for purposes of determining whether the $1,000,000 amount referred to in paragraph (a) of this section is equaled or exceeded, the taxable income for the short taxable year is computed by—

(i) Multiplying the taxable income for the short taxable year by 12; and

(ii) Dividing the resulting amount by the number of months in the short taxable year.

(2) *Computation of taxable income in taxable year when there occurs a transaction to which section 381 applies.* (i) For purposes of determining whether an acquiring corporation had taxable income of $1,000,000 or more for a taxable year in which a section 381 transaction occurs, the acquiring corporation's taxable income will be the sum of—

(A) The taxable income of the acquiring corporation for its taxable year; plus

(B) The taxable income (or loss) of the distributor or transferor corporation for that portion of its taxable year corresponding to the acquiring corporation's taxable year up to and including the date of distribution or transfer (as defined in §1.381(b)–1(b)).

(ii) For purposes of determining whether a transferor or distributor corporation had taxable income of $1,000,000 or more for a taxable year in which a section 381 transaction occurs, the distributor or transferor corporation's taxable income (or loss) is reduced by the amount of taxable income (or loss) that is included in the acquiring corporation's taxable income for the taxable year in which the distribution or transfer (as defined in §1.381(b)–1(b)) occurs, as described in paragraph (c)(2)(i)(B) of this section.

(d) *Members of controlled group*—(1) *In general.* For purposes of applying paragraph (a) of this section, the taxable income of members of a controlled group of corporations (as defined in section 1563(a)) must be aggregated for each year of the testing period. The provisions of this section do not apply to a controlled group for any taxable year in which the aggregate taxable income of the members of the controlled group is less than $1,000,000.

(2) *Aggregation.* For purposes of paragraph (d)(1) of this section, a taxable loss of any member of the controlled group for a taxable year during the testing period is not taken into account.

(3) *Allocation rule.* If the aggregate taxable income of members of a controlled group computed pursuant to paragraph (d)(1) of this section exceeds $1,000,000 during the testing period, the $1,000,000 amount that is relevant for purposes of determining, under paragraph (a)(1) of this section, whether a corporation is a large corporation is divided equally among the component members of such group (including component members excluded pursuant to paragraph (d)(2) of this section) unless all of such component members consent to an apportionment plan providing for an alternative allocation of such amount. The procedure for making and filing this plan will be the same as the procedure used for making and filing an apportionment plan under section 1561. See section 1561 and the regulations.

(4) *Controlled group members.* (i) In the case of any corporation that was a member of a controlled group of corporations at any time during the testing period but is not a member of such group during the taxable year involved, the taxable income of the former member for the testing period is determined as if such corporation were not a member of a group at any time during that period. With respect to the controlled group, the taxable income of its former member will not be taken into account in determining such group's taxable income for any taxable year during the testing period for purposes of applying paragraph (a)(1) of this section.

(ii) For purposes of paragraph (d)(4)(i) of this section, the determination of whether a corporation is a member of a controlled group during the testing period is based on whether the corporation was a member of the controlled group on the last day of the month preceding the due date of the required installment.

(e) *Effect on a corporation's taxable income of items that may be carried back or carried over from any other taxable year.* In determining whether a corporation (or predecessor corporation) is a large corporation for its current taxable year, items that could offset taxable income during a taxable year included in the testing period (for example, those described in sections 172 and 1212) are not to be taken into account and the taxable income of a corporation for any taxable year during the testing period is determined without regard to items carried back or carried over from any other taxable year.

(f) *Consolidated returns.* [Reserved]

(g) *Example.* The provisions of this section may be illustrated by the following example:

Example. Y Corporation and Z Corporation are calendar year taxpayers. In 2008, Z acquires all of the assets of Y in a transaction to which section 381 applies. Z's taxable income for both 2006 and 2007 was less than $1,000,000. Y's taxable income for 2008 is determined under paragraph (c)(2) of this section to be $300,000 for that portion of Y's taxable year corresponding to Z's taxable year up to and including the date of transfer. Z's taxable income for 2008 is $800,000. Under the provisions of paragraph (c)(2) of this section, Z's 2008 taxable income for purposes of determining whether it is a large corporation for taxable year 2009 is $1,100,000 ($800,000 + $300,000). Thus, Z is a large corporation for the 2009 taxable year. In addition, if Z's 2008 taxable income, as determined under paragraph (c)(2) of this section, had been less than $1,000,000 but Y's taxable income in 2006 or 2007 had been $1,000,000 or more, Z would be a large corporation for taxable year 2009 because Y is a predecessor corporation.

(h) *Effective/applicability date.* This section applies to taxable years beginning after September 6, 2007.

[T.D. 9347, 72 FR 44360, Aug. 7, 2007]

§ 1.6655–5 Short taxable year.

(a) *In general.* Except as otherwise provided in this section, the provisions of section 6655 and these regulations are applicable in the case of a short taxable year (including an initial taxable year) for which a payment of estimated tax is required to be made.

(b) *Exception to payment of estimated tax.* In the case of a short taxable year, no payment of estimated tax is required if—

(1) The short taxable year is a period of less than 4 full calendar months; or

(2) The tax shown on the return for such taxable year (or, if no return is filed, the tax) is less than $500.

(c) *Installment due dates*—(1) *In general*—(i) *Taxable year of at least four months but less than twelve months.* Except as otherwise provided, in the case of a short taxable year, if such year results in a taxable year of four or more full calendar months but less than twelve full calendar months, the due dates prescribed in §1.6655–1(f)(2) apply.

(ii) *Exceptions.* (A) If the date determined under paragraph (c)(1)(i) of this section for the first required installment due during the taxpayer's short taxable year is earlier than the 15th day of the fourth month of the taxpayer's short taxable year, the taxpayer's first required installment is due on the first due date otherwise determined under paragraph (c)(1)(i) of this section that is on or after the 15th day of the fourth month of the short taxable year.

(B) A taxpayer with an initial short taxable year may make estimated tax payments as though it were a calendar year taxpayer until it files its tax return for its initial taxable year and will not be subject to an addition to tax under section 6655 for making estimated tax payments as though it were a calendar year taxpayer for the period beginning with its initial short taxable year to the time it files its tax return for its initial short taxable year if, when filing its tax return for its initial short taxable year, the taxpayer chooses to be a fiscal year taxpayer.

(2) *Early termination of taxable year*—(i) *In general.* Except as provided in paragraph (c)(2)(ii) of this section, if a taxable year ends early (for example, as a result of an acquisition or a change in taxable year), the due date for the final required installment is the date that would have been the due date of the next required installment if the event that gave rise to the short taxable year had not occurred.

(ii) *Exception.* If the date determined under paragraph (c)(2)(i) of this section is within thirty days of the last day of the short taxable year, the due date for the final required installment is the fifteenth day of the second month following the month that includes the last day of the short taxable year.

(d) *Amount due for required installment*—(1) *In general.* The amount due for any required installment determined under section 6655(d)(1)(B)(i) for a short taxable year is 100% of the required annual payment for the short taxable year divided by the number of required installments due (as determined under this section) for the short taxable year.

(2) *Tax shown on the return for the preceding taxable year*. If the current taxable year is a short taxable year, the amount due for any required installment determined under section 6655(d)(1)(B)(ii) is determined in the following manner—

(i) Take 100% of the tax shown on the return of the corporation for the preceding taxable year;

(ii) Multiply such amount by the number of full calendar months in the current short taxable year and divide by 12; and

(iii) Divide the amount determined under paragraph (d)(2)(ii) of this section by the number of required installments due (as determined under this section) for the current short taxable year.

(3) *Applicable percentage*. In the case of any required installment determined under section 6655(e), the applicable percentage under section 6655(e)(2)(B)(ii) is—

(i) 25%, 50%, 75%, and 100% for the first, second, third, and fourth (last) required installments, respectively, if the taxpayer will have four required installments due for the short taxable year;

(ii) 33.33%, 66.67%, and 100% for the first, second, and third (last) required installments, respectively, if the taxpayer will have three required installments due for the short taxable year;

(iii) 50% and 100% for the first and second (last) required installments, respectively, if the taxpayer will have two required installments due for the short taxable year; or

(iv) 100% for the first (and last) required installment if the taxpayer will have one required installment for the short taxable year.

(4) *Applicable percentage for installment period in which taxpayer does not reasonably expect that the taxable year will be an early termination year*. In the case of any required installment determined under section 6655(e) in which the taxpayer does not reasonably expect that the taxable year will be an early termination year, the applicable percentage under section 6655(e)(2)(B)(ii) is the applicable percentage provided by paragraph (d)(3)(i) of this section with the remaining balance of the estimated tax payment for the year due with the final installment.

(e) *Examples*. The following examples illustrate the rules of this section:

Example 1. Short year of less than 4 months. Corporation A is a calendar year taxpayer that was acquired by corporation B, a member of a consolidated group (as defined in §1.1502–1(h)) on April 16, 2009, resulting in A having a short taxable year from January 1, 2009, through April 16, 2009. Because A has a taxable year of less than four full calendar months, no estimated tax payments are required by A for the short taxable year.

Example 2. Initial short year with four required installments. Corporation B began business on January 9, 2009, and adopted a calendar year as its taxable year. B computes its required installments based on 100 percent of the tax shown on the return for the taxable year in accordance with section 6655(d)(1)(B)(i). Pursuant to §1.6655–1(f)(2)(i), the due dates of B's required installments for B's initial taxable year from January 9, 2009, through December 31, 2009, are April 15, 2009, June 15, 2009, September 15, 2009, and December 15, 2009. Pursuant to paragraph (d)(1) of this section, the amount due with each required installment is 25% of the required annual payment for B's first required installment, 50% of the required annual payment for B's second required installment, 75% of the required annual payment for B's third required installment, and 100% of the required annual payment for B's fourth required installment.

Example 3. Initial short year with three required installments. Corporation C began business on February 12, 2009, and adopted a calendar year as its taxable year. C computes its required installments based on 100 percent of the tax shown on the return for the taxable year in accordance with section 6655(d)(1)(B)(i). Pursuant to §1.6655–1(f)(2)(i), the due dates of C's required installments for C's initial taxable year from February 12, 2009, through December 31, 2009, are April 15, 2009, June 15, 2009, September 15, 2009, and December 15, 2009. However, in accordance with paragraph (c)(1)(ii)(A) of this section, C's first required installment is due June 15, 2009, because April 15, 2009, is earlier than the fifteenth day of the fourth month of C's taxable year. As a result, C's second required installment is due September 15, 2009, and C's third (and last) installment is due December 15, 2009. Pursuant to paragraph (d)(1) of this section, the amount due with each required installment is 33.33% of the required annual payment for C's first required installment, 66.67% of the required annual payment for C's second required installment, and 100% of the required annual payment for C's third (and last) required installment.

Example 4. Initial short year with two required installments. Same facts as *Example 3* except C began business on April 10, 2009. In accordance with paragraph (c)(1)(ii)(A) of this section, C's first required installment is due September 15, 2009, because April 15, 2009, and June 15, 2009, are earlier than the fifteenth day of the fourth month of C's taxable year. As a result, C's second (and last) required installment is due December 15, 2009. Pursuant to paragraph (d)(1) of this section, the amount due with each required installment is 50% of the required annual payment for C's first required installment, and 100% of the required annual payment for C's second (and last) required installment.

Example 5. Initial short year for fiscal year taxpayer with two required installments. Corporation D began business on February 12, 2009, and adopted a fiscal year ending October 31 as its taxable year. D computes its required installments based on 100 percent of the tax shown on the return for the taxable year in accordance with section 6655(d)(1)(B)(i). Pursuant to §1.6655–1(f)(2)(ii), the due dates of D's required installments for D's initial taxable year from February 12, 2009, through October 31, 2009, are February 15, 2009, April 15, 2009, July 15, 2009, and October 15, 2009. However, in accordance with paragraph (c)(1)(ii)(A) of this section, D's first required installment is due July 15, 2009, because February 15, 2009, and April 15, 2009, are earlier than the fifteenth day of the fourth month of D's taxable year. As a result, D's second (and last) installment is due October 15, 2009. Pursuant to paragraph (d)(1) of this section, the amount due with each required installment is 50% of the required annual payment for D's first required installment, and 100% of the required annual payment for D's second (and last) required installment.

Example 6. Initial short year for fiscal year taxpayer with one required installment. Same facts as *Example 5* except D corporation began business on May 11, 2009. In accordance with paragraph (c)(1)(ii)(A) of this section, D's first (and last) installment is due October 15, 2009, because July 15, 2009, is earlier than the fifteenth day of the fourth month of D's taxable year. Pursuant to paragraph (d)(1) of this section, the amount due with D's required installment is 100% of the required annual payment, computed as 100% divided by the number of required installments due for the short taxable year.

Example 7. Short termination year with three required installments. Corporation E is a calendar year taxpayer that computes its required installments based on 100 percent of the tax shown on the return for the taxable year in accordance with section 6655(d)(1)(B)(i). E computes its 2009 required installments based on a projected 2009 total tax liability of $600,000. On July 31, 2009, E is acquired by corporation F, a member of a consolidated group (as defined in §1.1502–1(h)), resulting in E having a short taxable year from January 1, 2009, through July 31, 2009. E determines that its total tax liability for the short period is $350,000. The due dates for E's first and second required installments are April 15, 2009, and June 15, 2009, respectively. Pursuant to section 6655(d)(1)(A), E paid $150,000 with each required installment. Pursuant to paragraph (c)(2) of this section, E's third (and last) required installment of estimated tax is due on September 15, 2009, and the percentage of the required annual payment due with such installment is 100% pursuant to paragraph (d)(1) of this section. Accordingly, E is required to pay $50,000 with its final required installment on September 15, 2009 ($350,000 total tax liability for the short taxable year less prior installment payments of $300,000).

Example 8. Unexpected short termination year with three required installments using the annualization method. Same facts as *Example 7* except that E uses the annualized income installment method under section 6655(e)(2)(A)(i) to calculate all of its required installment payments for its 2009 taxable year. In addition, E does not reasonably expect until July 28, 2009, that it will have a short termination year caused by E being acquired by F on July 31, 2009. Had E known about its acquisition by F in the first quarter of 2009, E's applicable percentages for computing the amount of its three required installments would be 33.33%, 66.67%, and 100% for the first, second, and third (last) required installments, respectively, pursuant to paragraph (d)(3)(ii) of this section. However, because E had an unexpected short termination year that E was not aware of until after its second required installment payment, E's applicable percentages for computing the amount of its three required installment are 25%, 50%, and 100% for the first, second, and third (last) required installments, respectively, pursuant to paragraph (d)(4) of this section.

Example 9. Short termination year ending within 30 days of the regular final installment due date. Same facts as *Example 7* except that E is acquired by F on August 31, 2009. Pursuant to paragraph (c)(2)(ii) of this section, E's third (and last) required installment of estimated tax is due on October 15, 2009, because September 15, 2009, the date that would have been the due date of E's next required installment if F's acquisition of E had not occurred, is within thirty days of the last day of E's short taxable year, and 100% of the required annual payment is due with such installment.

Example 10. Short termination year ending within 30 days of the regular final installment due date. Corporation F is a calendar year taxpayer that computes its required installments based on 100 percent of the tax shown on the return for the taxable year in accordance with section 6655(d)(1)(B)(i). F computes its 2009 estimated tax payments based on a projected 2009 total tax liability of $900,000. On December 3, 2009, F is acquired by corporation G, a member of a consolidated group (as defined in §1.1502–2(h)), resulting in F having a short taxable year from January 1, 2009, through December 3, 2009. F determined its total tax liability for the short period to be $800,000. The due dates for F's first, second, and third required installments are April 15, 2009, June 15, 2009, and September 15, 2009, respectively. Pursuant to section 6655(d)(1)(A), F paid $225,000 with each required installment. Pursuant to paragraph (c)(2)(ii) of this section, F's fourth (and last) required installment of estimated tax is due on February 15, 2010, and the percentage of the required annual payment due with such installment is 100% pursuant to paragraph (d)(1) of this section. However, because the due date for the fourth required installment falls on a legal holiday, F's required installment payment will be timely if paid on or before the first business day following the actual due date of the fourth required installment, that is, February 16, 2010. Accordingly, F is required to pay $125,000 with its final required installment on February 16, 2010 ($800,000 total tax liability for the short taxable year less prior installment payments of $675,000).

Example 11. Short termination year using the tax shown on the return for the preceding taxable year. Corporation G, a calendar year taxpayer, reported a tax liability of $75,000 on its return for the taxable year ending December 31, 2008, and is not a large corporation as defined in section 6655(g). On July 31, 2009, G makes a final distribution of its assets, in connection with a plan of complete liquidation, resulting in a short taxable year from January 1, 2009, through July 31, 2009. To satisfy the requirements of the exception described in section 6655(d)(1)(B)(ii) for payments determined by reference to the tax shown on the return of the corporation for the preceding taxable year, pursuant to paragraph (d)(2) of this section, G must pay in a proportionate amount of its 2008 tax liability based on the number of months in the current taxable year. Accordingly, G must pay $43,750 ($75,000 × 7⁄12) through payments of estimated tax payments in 2009, with $14,583 due on April 15, 2009, June 15, 2009, and September 15, 2009.

Example 12. Short termination year using the tax shown on the return for the preceding taxable year. Same facts as *Example 11* except that G makes a final distribution of its assets, in connection with a plan of complete liquidation, on October 1, 2009, resulting in a short taxable year from January 1, 2009, through October 1, 2009. To satisfy the requirements of the exception described in section 6655(d)(1)(B)(ii), G must pay $56,250 ($75,000 × 9⁄12) through payments of estimated tax in 2009, with $14,063 due on April 15, 2009, June 15, 2009, September 15, 2009, and December 15, 2009, respectively.

Example 13. Short initial year with three required installments resulting in an underpayment. (i) Corporation H began business on February 17, 2009, and adopted a calendar year. H computes its required installments based on 100 percent of the tax shown on the return for the taxable year in accordance with section 6655(d)(1)(B)(i). H estimated at the beginning of its short taxable year that its estimated tax liability for short taxable year February 17, 2009, through December 31, 2009, would be $180,000. H paid its first required installment of estimated tax of $60,000 on June 15, 2009, its second required installment of estimated tax of $60,000 on September 15, 2009, and its third (and last) required installment of estimated tax of $60,000 on December 15, 2009 ($180,000 total estimated tax liability for the short taxable year less prior installment payments of $120,000). H reported a tax liability of $240,000 on its return for the short period February 17, 2009, through December 31, 2009, with no credits against tax. There was an underpayment in the amount of $20,000 on the first installment date through September 15, 2009, $40,000 on the second installment date through December 15, 2009, and $60,000 on the third (and last) installment date through March 15, 2010, determined as follows:

(A) Tax as defined in section 6655(d)(1)(B)(i) = $240,000

(B) 100% of this paragraph (e), *Example 13* (A) = $240,000

(C) Amount of estimated tax required to be paid by the first installment date (33.33% of $240,000) = $80,000

(D) Amount of estimated tax required to be paid by the second installment date (66.67% of $240,000 less $80,000 (amount due with first installment)) = $80,000

(E) Amount of estimated tax required to be paid by the third installment date (100% of $240,000 less $160,000 (amount due with first and second installment)) = $80,000

(F) Deduction of amount paid on or before the first installment date = $60,000

(G) Amount of underpayment for the first installment date (this paragraph (e), *Example 13* (i)(C) minus this paragraph (e), *Example 13* (i)(F)) = $20,000

(H) Deduction of amount available for the second installment date ($60,000 second installment payment less this paragraph (e), *Example 13* (i)(G) applied towards the first installment underpayment) = $40,000

(I) Amount of underpayment for the second installment date (this paragraph (e), *Example 13* (i)(D) minus this paragraph (e), *Example 13* (i)(H)) = $40,000

(J) Deduction of amount available for the third installment date ($60,000 third installment payment less this paragraph (e), *Example 13* (i)(I) applied towards the second installment underpayment) = $20,000

(K) Amount of underpayment for the third installment date (this paragraph (e), *Example 1* (i)(E) minus this paragraph (e), *Example 13* (i)(J)) = $60,000

(ii) [Reserved]

(f) *52 or 53 week taxable year*. For purposes of this section a taxable year of 52 or 53 weeks is deemed a period of 12 months in the case of a corporation that computes its taxable income in accordance with the election permitted by section 441(f).

(g) *Use of annualized income or seasonal installment method*—(1) *In general*. Regardless of the annual accounting period used by a corporation (for example, calendar year, fiscal year) the taxpayer may use the method described in §1.6655–2 (annualized income installment method) or §1.6655–3 (adjusted seasonal installment method) to compute its required installments of estimated tax when the current taxable year is a short taxable year.

(2) *Computation of annualized income installment*. To the extent a short taxable year includes an annualization period elected by the taxpayer, the taxpayer computes its annualized income installment by determining the tax on the basis of such annualized income for the annualization period, divided by 12, multiplied by the number of months in the short taxable year, and multiplied by the applicable percentage for the required installment.

(3) *Annualization period for final required installment*. For purposes of determining the final required installment (as described in paragraph (c)(2) of this section) for a short taxable year, annualized taxable income is determined by placing on an annualized basis the taxable income for the last complete annualization period that occurs within the short taxable year.

(4) *Examples*. The provisions of paragraph (g) of this section may be illustrated by the following examples:

Example 1. Corporation X began business on February 12, 2009, and adopted a calendar year as its taxable year. X adopts an accrual method of accounting and uses the annualized income installment method under section 6655(e)(2)(A)(i) to calculate all of its required installment payments for its 2009 taxable year. Pursuant to §1.6655–1(f)(2)(i), the due dates of X's required installments for X's initial taxable year from February 12, 2009, through December 31, 2009, are April 15, 2009, June 15, 2009, September 15, 2009, and December 15, 2009. However, in accordance with paragraph (c)(1)(ii)(A) of this section, X's first required installment is due June 15, 2009. As a result, X's second required installment is due September 15, 2009, and X's third (and last) required installment is due December 15, 2009. The amount of X's first and second required installments are each based on annualizing X's taxable income from February 12, 2009, through April 30, 2009, (the first three months of X's taxable year) and X's third (and last) required installment is based on annualizing X's taxable income from February 12, 2009, through July 31, 2009 (the first six months of X's taxable year). Because X will have three required installments due for its short taxable year, pursuant to paragraph (d)(3)(ii) of this section, the applicable percentage is 33.33% for X's first required installment, 66.67% for X's second required installment, and 100% for X's third (and last) required installment.

Example 2. (i) Y, a calendar year corporation, made a final distribution of its assets, in connection with a plan of complete liquidation, on August 3, 2009. Y filed a timely election to use the alternative annualization periods described under section 6655(e)(2)(C)(i) and determined that its taxable income for the first 2, 4 and 7 months of the taxable year was $25,000, $50,000 and $140,000. The due dates for Y's required installments for its short taxable year January 1, 2009, through August 3, 2009, are April 15, 2009, June 15, 2009, and September 15, 2009. Y made installment payments of $10,000, $10,000, and $20,000, respectively, on April 15, 2009, June 15, 2009, and September 15, 2009. The taxable income for each period is annualized as follows:

$25,000 × 12/2 = $150,000
$50,000 × 12/4 = $150,000
$140,000 × 12/7 = $240,000

(ii)(A) To determine whether the first required installment equals or exceeds the amount that would have been required to have been paid if the estimated tax were equal to one hundred percent of the tax computed on the annualized income for the 2-month period taking into account the number of months in the short taxable year, the following computation is necessary:

(*1*) Annualized income for the 2 month period = $150,000

(*2*) Tax on this paragraph (g)(4), *Example 2* (ii)(A)(*1*) = $41,750

(*3*) Tax determined under this paragraph (g)(4), *Example 2* (ii)(A)(*2*) divided by 12 multiplied by 7 (the number of months in the short taxable year) = $24,354

(*4*) 100% of this paragraph (g)(4), *Example 2* (ii)(A)(*3*) = $24,354

(*5*) 33.33% of this paragraph (g)(4), *Example 2* (ii)(A)(*4*) = $ 8,117

(B) Because the total amount of estimated tax that is timely paid on or before the first installment date ($10,000) exceeds the amount required to be paid on or before this date if the estimated tax were one hundred percent of the tax determined by placing on an annualized basis the taxable income for the first 2-month period taking into account the number of months in the short taxable year, the exception described in §1.6655–2(a) applies and no addition to tax will be imposed for the installment due on April 15, 2009.

(iii)(A) To determine whether the required installments made on or before June 15, 2009, equal or exceed the amount that would have been required to have been paid if the estimated tax were equal to one hundred percent of the tax computed on the annualized income for the 4-month period taking into account the number of months in the short taxable year, the following computation is necessary:

(*1*) Annualized income for the 4 month period = $150,000

(*2*) Tax on this paragraph (g)(4), *Example 2* (iii)(A)(*1*) = $41,750

(*3*) Tax determined under this paragraph (g)(4), *Example 2* (iii)(A)(*2*) divided by 12 multiplied by 7 (the number of months in the short taxable year) = $24,354

(*4*) 100% of this paragraph (g)(4), *Example 2* (iii)(A)(*3*) = $24,354

(*5*) 66.67% of this paragraph (g)(4), *Example 2* (iii)(A)(*4*) less $8,117 (amount due with first installment) = $8,120

(B) Because the total amount of estimated tax available to apply towards the amount due for the second installment ($11,883 ($10,000 paid on the second installment date plus $1,883 overpayment of the first installment)) exceeds the amount required to be paid on or before this date if the estimated tax were one hundred percent of the tax determined by placing on an annualized basis the taxable income for the first 4-month period for the taxable year taking into account the number of months in the short taxable year, the exception described in §1.6655–2(a) applies and no addition to tax will be imposed for the installment due on June 15, 2009.

(iv)(A) Pursuant to paragraph (c) and (d) of this section, the final required installment is due by September 15, 2009, and the applicable percentage due for the final required installment is 100%. To determine whether the installment payments made on or before September 15, 2009, equal or exceed the amount that would have been required to have been paid if the estimated tax were equal to one hundred percent of the tax computed on the annualized income for the 7-month period taking into account the number of months in the short taxable year, the following computation is necessary:

(*1*) Annualized income for the 7 month period = $240,000

(*2*) Tax on this paragraph (g)(4), *Example 2* (iv)(A)(*1*) = $76,850

(*3*) Tax determined under this paragraph (g)(4), *Example 2* (iv)(A)(*2*) divided by 12 multiplied by 7 (the number of months in the short taxable year) = $44,829

(*4*) 100% of this paragraph (g)(4), *Example 2* (iv)(A)(*3*) = $44,829

(*5*) 100% of this paragraph (g)(4), *Example 2* (iv)(A)(*4*) less $16,237 (amount due with first and second installment) = $28,592

(B) Because the total amount of estimated tax available to apply towards the amount due for the final installment ($23,763 ($20,000 that is timely paid on the third installment date plus $3,763 overpayment of the second installment)) does not exceed the amount required to be paid on or before this date if the estimated tax were one hundred percent of the tax determined by placing on an annualized basis the taxable income for the first 7-month period for the taxable year taking into account the number of months in the short taxable year, the exception described in §1.6655–2(a) does not apply and an addition to tax will be imposed for the final installment due on September 15, 2009, unless another exception (for example, see section 6655(e)(3)) applies with respect to these installments.

(h) *Effective/applicability date*. This section applies to taxable years beginning after September 6, 2007.

[T.D. 9347, 72 FR 44361, Aug. 7, 2007]

§ 1.6655–6 Methods of accounting.

(a) *In general*. In computing any required installment, a corporation must use the methods of accounting used in computing taxable income for the taxable year for which estimated tax is being determined (the current taxable year).

(b) *Accounting method changes*. A taxpayer that changes its method of accounting with the consent of the Commissioner for the current taxable year must use the new method of accounting (as of the beginning of the taxable year) in the determination of taxable income for annualization periods ending on or after the date the related section 481(a) adjustment is treated as arising. See §1.6655–2(f)(3)(ii)(C) for the date a section 481(a) adjustment is treated as arising. If the change in method of accounting does not result in a section 481(a) adjustment, the taxpayer may choose to use the new method of accounting (as of the beginning of the taxable year) in the determination of taxable income for all annualization periods during the year of change or only those annualization periods ending on or after the date the Form 3115 ''Application for Change in Accounting Method'' was filed with the national office of the Internal Revenue Service. This paragraph (b) only applies to the extent a taxpayer changes a method of accounting for the taxable year with the consent of the Commissioner. Therefore, a taxpayer may be subject to a section 6655 addition to tax for an underpayment of estimated tax if an underpayment results from a change in a method of accounting the taxpayer anticipates making for the taxable year but for which the consent of the Commissioner is not subsequently received.

(c) *Examples.* The following examples illustrate the rules of this section:

Example 1. Accounting method used in computing taxable income for the taxable year. Corporation ABC, a calendar year taxpayer, uses an accrual method of accounting and the annualization method under section 6655(e)(2)(A)(i) to calculate all of its 2008 required installments. ABC receives advance payments each taxable year with respect to agreements for the sale of goods properly includible in ABC's inventory. The advance payments received by ABC qualify for deferral under §1.451–5(c). Although ABC is eligible to defer the advance payments in accordance with §1.451–5(c), ABC's method of accounting with respect to the advance payments is to include the advance payments in income when received and ABC does not change its accounting method for advance payments for the 2008 taxable year. ABC must use its current method of recognizing advance payments as income in the year received for purposes of computing its 2008 required installments.

Example 2. Change of accounting method. Corporation ABC, a calendar year taxpayer, uses an accrual method of accounting and the annualization method under section 6655(e)(2)(A)(i) to calculate all of its 2008 required installments. On June 15, 2008, ABC files a Form 3115 requesting permission to change its method of accounting for future litigation reserves for the tax year ending December 31, 2008. On February 15, 2009, ABC receives consent from the Commissioner to make the change for the tax year ending December 31, 2008. The change results in a positive section 481(a) adjustment of $100,000. Under the provisions of §1.6655–2(f)(3)(ii) ABC chooses to treat the section 481(a) adjustment as arising on the date the Form 3115 is filed with the national office of the Internal Revenue Service. Therefore, ABC is required to use the new method of accounting (as of the beginning of the year) in the determination of taxable income for annualization periods ending on or after June 15, 2008.

(d) *Effective/applicability date.* This section applies to taxable years beginning after September 6, 2007.

[T.D. 9347, 72 FR 44361, Aug. 7, 2007]

§ 1.6655–7 Addition to tax on account of excessive adjustment under section 6425.

(a) Section 6655(h) imposes an addition to the tax under chapter 1 of the Internal Revenue Code in the case of any excessive amount (as defined in paragraph (c) of this section) of an adjustment under section 6425 that is made before the 15th day of the third month following the close of a taxable year beginning after December 31, 1967. This addition to tax is imposed whether or not there was reasonable cause for an excessive adjustment.

(b) If the amount of an adjustment under section 6425 is excessive, there shall be added to the tax under chapter 1 of the Internal Revenue Code for the taxable year an amount determined at the annual rate referred to in the regulations under section 6621 upon the excessive amount from the date on which the credit is allowed or refund paid to the 15th day of the third month following the close of the taxable year. A refund is paid on the date it is allowed under section 6407.

(c) The excessive amount is equal to the lesser of the amount of the adjustment or the amount by which—

(1) The income tax liability (as defined in section 6425(c)) for the taxable year, as shown on the return for the taxable year; exceeds

(2) The estimated income tax paid during the taxable year, reduced by the amount of the adjustment.

(d) The computation of the addition to the tax imposed by section 6425 is made independent of, and does not affect the computation of, any addition to the tax that a corporation may otherwise owe for an underpayment of an installment of estimated tax.

(e) The following example illustrates the rules of this section:

Example. (i) Corporation X, a calendar year taxpayer, had an underpayment as defined in section 6655(b), for its fourth installment of estimated tax that was due on December 15, 2009, in the amount of $10,000. On January 4, 2010, X filed an application for adjustment of overpayment of estimated income tax for 2009 in the amount of $20,000.

(ii) On February 16, 2010, the Internal Revenue Service, in response to the application, refunded $20,000 to X. On March 15, 2010, X filed its 2009 tax return and made a payment in settlement of its total tax liability. Assuming that the addition to tax is computed under section 6621(a)(2) at a rate of 8% per annum for the applicable periods of underpayment, under section 6655(a), X is subject to an addition to tax in the amount of $197 (90/365 X $10,000 X 8%) on account of X's December 15, 2009, underpayment. Under section 6655(h), X is subject to an addition to tax in the amount of $118 (27/365 X $20,000 X 8%) on account of X's excessive adjustment under section 6425. In determining the amount of the addition to tax under section 6655(a) for failure to pay estimated income tax, the excessive adjustment under section 6425 is not taken into account.

(f) An adjustment is generally to be treated as a reduction of estimated income tax paid as of the date of the adjustment. However, for purposes of §§ 1.6655–1 through 1.6655–6, the adjustment is to be treated as if not made in determining whether there has been any underpayment of estimated income tax and, if there is an underpayment, the period during which the underpayment existed.

(g) *Effective/applicability date:* This section applies to taxable years beginning after September 6, 2007.

[T.D. 9347, 72 FR 44365, Aug. 7, 2007]

§ 1.6655(e)–1 Time and manner for making election under the Omnibus Budget Reconciliation Act of 1993.

(a) *Description.* Section 6655(e)(2)(C), as added by section 13225 of the Omnibus Budget Reconciliation Act of 1993 (Pub. L. 103–66, 107 Stat. 486), allows a corporate taxpayer to make an annual election to use a different annualization period to determine annualized income for purposes of paying any required installment of estimated income tax for a taxable year beginning after December 31, 1993.

(b) *Time and manner for making the election.* An election under section 6655(e)(2)(C) must be made on or before the date required for the payment of the first required installment for the taxable year. For a calendar or fiscal year corporation, Form 8842, Election to Use Different Annualization Periods for Corporate Estimated Tax, must be filed by the 15th day of the 4th month of the taxable year for which the election is to apply. Form 8842 must be filed with the Internal Revenue Service Center where the corporation files its income tax return.

(c) *Revocability of election.* The election described in this section is irrevocable.

(d) *Effective date.* The rules set forth in this section are effective December 12, 1996.

[T.D. 8688, 61 FR 65322, Dec. 12, 1996]

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[T.D. 8381, 56 FR 67497, Dec. 31, 1991; T.D. 8381, 57 FR 6165, Feb. 20, 1992, as amended by T.D. 8519, 59 FR 4794, Feb. 2, 1994; T.D. 8533, 59 FR 12548, Mar. 17, 1994; T.D. 8551, 59 FR 35031, July 8, 1994; T.D. 8617, 60 FR 45663, Sept. 1, 1995; T.D. 8656, 61 FR 4879, Feb. 9, 1996; T.D. 8656, 61 FR 14248, Apr. 1, 1996; T.D. 8790, 63 FR 66434, Dec. 2, 1998; T.D. 9109, 68 FR 75127, Dec. 30, 2003]

§ 1.6662–1 Overview of the accuracy-related penalty.

Section 6662 imposes an accuracy-related penalty on any portion of an underpayment of tax required to be shown on a return that is attributable to one or more of the following:

(a) Negligence or disregard of rules or regulations;

(b) Any substantial understatement of income tax;

(c) Any substantial valuation misstatement under chapter 1;

(d) Any substantial overstatement of pension liabilities; or

(e) Any substantial estate or gift tax valuation understatement.

Sections 1.6662–1 through 1.6662–5 address only the first three components of the accuracy-related penalty, *i.e.*, the penalties for negligence or disregard of rules or regulations, substantial understatements of income tax, and substantial (or gross) valuation misstatements under chapter 1. The penalties for disregard of rules or regulations and for a substantial understatement of income tax may be avoided by adequately disclosing certain information as provided in § 1.6662–3(c) and §§ 1.6662–4(e) and (f), respectively. The penalties for negligence and for a substantial (or gross) valuation misstatement under chapter 1 may not be avoided by disclosure. No accuracy-related penalty may be imposed on any portion of an underpayment if there was reasonable cause for, and the taxpayer acted in good faith with respect to, such portion. The reasonable cause and good faith exception to the accuracy-related penalty is set forth in § 1.6664–4.

[T.D. 8381, 56 FR 67498, Dec. 31, 1991, as amended by T.D. 8617, 60 FR 45664, Sept. 1, 1995]

§ 1.6662–2 Accuracy-related penalty.

(a) *In general.* Section 6662(a) imposes an accuracy-related penalty on any portion of an underpayment of tax (as defined in section 6664(a) and § 1.6664–2) required to be shown on a return if such portion is attributable to one or more of the following types of misconduct:

(1) Negligence or disregard of rules or regulations (see § 1.6662–3);

(2) Any substantial understatement of income tax (see § 1.6662–4); or

(3) Any substantial (or gross) valuation misstatement under chapter 1 (''substantial valuation misstatement'' or ''gross valuation misstatement''), provided the applicable dollar limitation set forth in section 6662(e)(2) is satisfied (see § 1.6662–5).

The accuracy-related penalty applies only in cases in which a return of tax is filed, except that the penalty does not apply in the case of a return prepared by the Secretary under the authority of section 6020(b). The accuracy-related penalty under section 6662 and the penalty under section 6651 for failure to timely file a return of tax may both be imposed on the same portion of an underpayment if a return is filed, but is filed late. The fact that a return is filed late, however, is not taken into account in determining whether an accuracy-related penalty should be imposed. No accuracy-related penalty may be imposed on any portion of an underpayment of tax on which the fraud penalty set forth in section 6663 is imposed.

(b) *Amount of penalty*—(1) *In general.* The amount of the accuracy-related penalty is 20 percent of the portion of an underpayment of tax required to be shown on a return that is attributable to any of the types of misconduct listed in paragraphs (a)(1) through (a)(3) of this section, except as provided in paragraph (b)(2) of this section.

(2) *Increase in penalty for gross valuation misstatement.* In the case of a gross valuation misstatement, as defined in section 6662(h)(2) and §1.6662–5(e)(2), the amount of the accuracy-related penalty is 40 percent of the portion of an underpayment of tax required to be shown on a return that is attributable to the gross valuation misstatement, provided the applicable dollar limitation set forth in section 6662(e)(2) is satisfied.

(c) *No stacking of accuracy-related penalty components.* The maximum accuracy-related penalty imposed on a portion of an underpayment may not exceed 20 percent of such portion (40 percent of the portion attributable to a gross valuation misstatement), notwithstanding that such portion is attributable to more than one of the types of misconduct described in paragraph (a) of this section. For example, if a portion of an underpayment of tax required to be shown on a return is attributable both to negligence and a substantial understatement of income tax, the maximum accuracy-related penalty is 20 percent of such portion. Similarly, the maximum accuracy-related penalty imposed on any portion of an underpayment that is attributable both to negligence and a gross valuation misstatement is 40 percent of such portion.

(d) *Effective dates*—(1) *Returns due before January 1, 1994.* Section 1.6662–3(c) and §§1.6662–4 (e) and (f) (relating to methods of making adequate disclosure) (as contained in 26 CFR part 1 revised April 1, 1995) apply to returns the due date of which (determined without regard to extensions of time for filing) is after December 31, 1991, but before January 1, 1994. Except as provided in the preceding sentence and in paragraphs (d)(2), (3), and (4) of this section, §§1.6662–1 through 1.6662–5 apply to returns the due date of which (determined without regard to extensions of time for filing) is after December 31, 1989, but before January 1, 1994. To the extent the provisions of these regulations were not reflected in the statute as amended by the Omnibus Budget Reconciliation Act of 1989 (OBRA 1989), in Notice 90–20, 1990–1 C.B. 328, or in rules and regulations in effect prior to March 4, 1991 (to the extent not inconsistent with the statute as amended by OBRA 1989), these regulations will not be adversely applied to a taxpayer who took a position based upon such prior rules on a return filed before January 1, 1992.

(2) *Returns due after December 31, 1993.* Except as provided in paragraphs (d)(3), (4) and (5) of this section and the last sentence of this paragraph (d)(2), the provisions of §§1.6662–1 through 1.6662–4 and §1.6662–7 (as revised to reflect the changes made to the accuracy-related penalty by the Omnibus Budget Reconciliation Act of 1993) and of §1.6662–5 apply to returns the due date of which (determined without regard to extensions of time for filing) is after December 31, 1993. These changes include raising the disclosure standard for the penalties for disregarding rules or regulations and for a substantial understatement of income tax from not frivolous to reasonable basis, eliminating the disclosure exception for the negligence penalty, and providing guidance on the meaning of reasonable basis. The Omnibus Budget Reconciliation Act of 1993 changes relating to the penalties for negligence or disregard of rules or regulations will not apply to returns (including qualified amended returns) that are filed on or before March 14,

1994, but the provisions of §§ 1.6662–1 through 1.6662–3 (as contained in 26 CFR part 1 revised April 1, 1995) relating to those penalties will apply to such returns.

(3) *Special rules for tax shelter items.* Sections 1.6662–4(g)(1) and 1.6662–4(g)(4) apply to returns the due date of which (determined without regard to extensions of time for filing) is after September 1, 1995. Except as provided in the last sentence of this paragraph (d)(3), §§ 1.6662–4(g)(1) and 1.6662–4(g)(4) (as contained in 26 CFR part 1 revised April 1, 1995) apply to returns the due date of which (determined without regard to extensions of time for filing) is on or before September 1, 1995 and after December 31, 1989. For transactions occurring after December 8, 1994, §§ 1.6662–4(g)(1) and 1.6662–4(g)(2) (as contained in 26 CFR part 1 revised April 1, 1995) are applied taking into account the changes made to section 6662(d)(2)(C) (relating to the substantial understatement penalty for tax shelter items of corporations) by section 744 of title VII of the Uruguay Round Agreements Act, Pub. L. 103–465 (108 Stat. 4809).

(4) *Special rules for reasonable basis.* Section 1.6662–3(b)(3) applies to returns filed on or after December 2, 1998.

(5) *For returns filed after December 31, 2002.* Sections 1.6662–3(a), 1.6662–3(b)(2) and 1.6662–3(c)(1) (relating to adequate disclosure) apply to returns filed after December 31, 2002, with respect to transactions entered into on or after January 1, 2003. Except as provided in paragraph (d)(1) of this section, §§ 1.6662–3(a), 1.6662–3(b)(2) and 1.6662–3(c)(1) (as contained in 26 CFR part 1 revised April 1, 2003) apply to returns filed with respect to transactions entered into prior to January 1, 2003.

[T.D. 8381, 56 FR 67498, Dec. 31, 1991, as amended by T.D. 8617, 60 FR 45664, Sept. 1, 1995; T.D. 8790, 63 FR 66434, Dec. 2, 1998; T.D. 9109, 68 FR 75127, Dec. 30, 2003]

§ 1.6662–3 Negligence or disregard of rules or regulations.

(a) *In general.* If any portion of an underpayment, as defined in section 6664(a) and § 1.6664–2, of any income tax imposed under subtitle A of the Internal Revenue Code that is required to be shown on a return is attributable to negligence or disregard of rules or regulations, there is added to the tax an amount equal to 20 percent of such portion. The penalty for disregarding rules or regulations does not apply, however, if the requirements of paragraph (c)(1) of this section are satisfied and the position in question is adequately disclosed as provided in paragraph (c)(2) of this section (and, if the position relates to a reportable transaction as defined in § 1.6011–4(b) (or § 1.6011–4T(b), as applicable), the transaction is disclosed in accordance with § 1.6011–4 (or § 1.6011–4T, as applicable)), or to the extent that the reasonable cause and good faith exception to this penalty set forth in § 1.6664–4 applies. In addition, if a position with respect to an item (other than with respect to a reportable transaction, as defined in § 1.6011–4(b) or § 1.6011–4T(b), as applicable) is contrary to a revenue ruling or notice (other than a notice of proposed rulemaking) issued by the Internal Revenue Service and published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter), this penalty does not apply if the position has a realistic possibility of being sustained on its merits. See § 1.6694–2(b) of the income tax return preparer penalty regulations for a description of the realistic possibility standard.

(b) *Definitions and rules*—(1) *Negligence.* The term *negligence* includes any failure to make a reasonable attempt to comply with the provisions of the internal revenue laws or to exercise ordinary and reasonable care in the preparation of a tax return. ''Negligence'' also includes any failure by the taxpayer to keep adequate books and records or to substantiate items properly. A return position that has a reasonable basis as defined in paragraph (b)(3) of this section is not attributable to negligence. Negligence is strongly indicated where—

(i) A taxpayer fails to include on an income tax return an amount of income shown on an information return, as defined in section 6724(d)(1);

(ii) A taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return which would seem to a reasonable and prudent person to be ''too good to be true'' under the circumstances;

(iii) A partner fails to comply with the requirements of section 6222, which requires that a partner treat partnership items on its return in a manner that is consistent with the treatment of such items on the partnership return (or notify the Secretary of the inconsistency); or

(iv) A shareholder fails to comply with the requirements of section 6242, which requires that an S corporation shareholder treat subchapter S items on its return in a manner that is consistent with the treatment of such items on the corporation's return (or notify the Secretary of the inconsistency).

(2) *Disregard of rules or regulations.* The term *disregard* includes any careless, reckless or intentional disregard of rules or regulations. The term ''rules or regulations'' includes the provisions of the Internal Revenue Code, temporary or final Treasury regulations issued under the Code, and revenue rulings or notices (other than notices of proposed rulemaking) issued by the Internal Revenue Service and published in the Internal Revenue Bulletin. A disregard of rules or regulations is ''careless'' if the taxpayer does not exercise reasonable diligence to determine the correctness of a return position that is contrary to the rule or regulation. A disregard is ''reckless'' if the taxpayer makes little or no effort to determine whether a rule or regulation exists, under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable person would observe. A disregard is ''intentional'' if the taxpayer knows of the rule or regulation that is disregarded. Nevertheless, a taxpayer who takes a position (other than with respect to a reportable transaction, as defined in §1.6011–4(b) or §1.6011–4T(b), as applicable) contrary to a revenue ruling or notice has not disregarded the ruling or notice if the contrary position has a realistic possibility of being sustained on its merits.

(3) *Reasonable basis.* Reasonable basis is a relatively high standard of tax reporting, that is, 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 even though it may not satisfy the substantial authority standard as defined in §1.6662–4(d)(2). (See §1.6662–4(d)(3)(ii) for rules with respect to relevance, persuasiveness, subsequent developments, and use of a well-reasoned construction of an applicable statutory provision for purposes of the substantial understatement penalty.) In addition, the reasonable cause and good faith exception in §1.6664–4 may provide relief from the penalty for negligence or disregard of rules or regulations, even if a return position does not satisfy the reasonable basis standard.

(c) *Exception for adequate disclosure*—(1) *In general.* No penalty under section 6662(b)(1) may be imposed on any portion of an underpayment that is attributable to a position contrary to a rule or regulation if the position is disclosed in accordance with the rules of paragraph (c)(2) of this section (and, if the position relates to a reportable transaction as defined in §1.6011–4(b) (or §1.6011–4T(b), as applicable), the transaction is disclosed in accordance with §1.6011–4 (or §1.6011–4T, as applicable)) and, in case of a position contrary to a regulation, the position represents a good faith challenge to the validity of the regulation. This disclosure exception does not apply, however, in the case of a position that does not have a reasonable basis or where the taxpayer fails to keep adequate books and records or to substantiate items properly.

(2) *Method of disclosure.* Disclosure is adequate for purposes of the penalty for disregarding rules or regulations if made in accordance with the provisions of §§1.6662–4(f)(1), (3), (4), and (5), which permit disclosure on a properly completed and filed Form 8275 or 8275–R, as appropriate. In addition, the statutory or regulatory provision or ruling in question must be adequately identified on the Form 8275 or 8275–R, as appropriate. The provisions of §1.6662–4(f)(2), which permit disclosure in accordance

with an annual revenue procedure for purposes of the substantial understatement penalty, do not apply for purposes of this section.

(d) *Special rules in the case of carrybacks and carryovers*—(1) *In general*. The penalty for negligence or disregard of rules or regulations applies to any portion of an underpayment for a year to which a loss, deduction or credit is carried, which portion is attributable to negligence or disregard of rules or regulations in the year in which the carryback or carryover of the loss, deduction or credit arises (the ''loss or credit year'').

(2) *Transition rule for carrybacks to pre-1990 years*. A 20 percent penalty under section 6662(b)(1) is imposed on any portion of an underpayment for a carryback year, the return for which is due (without regard to extensions) before January 1, 1990, if—

(i) That portion is attributable to negligence or disregard of rules or regulations in a loss or credit year; and

(ii) The return for the loss or credit year is due (without regard to extensions) after December 31, 1989.

(3) *Example*. The following example illustrates the provisions of paragraph (d) of this section. This example does not take into account the reasonable cause exception under §1.6664–4.

Example. Corporation M is a C corporation. In 1990, M had a loss of $200,000 before taking into account a deduction of $350,000 that M claimed as an expense in careless disregard of the capitalization requirements of section 263 of the Code. M failed to make adequate disclosure of the item for 1990. M reported a $550,000 loss for 1990 and carried back the loss to 1987 and 1988. M had reported taxable income of $400,000 for 1987 and $200,000 for 1988, before application of the carryback. The carryback eliminated all of M's taxable income for 1987 and $150,000 of taxable income for 1988. After disallowance of the $350,000 expense deduction and allowance of a $35,000 depreciation deduction with respect to the capitalized amount, the correct loss for 1990 was determined to be $235,000. Because there is no underpayment for 1990, the penalty for negligence or disregard of rules or regulations does not apply for 1990. However, as a result of the 1990 adjustments, the loss carried back to 1987 is reduced from $550,000 to $235,000. After application of the $235,000 carryback, M has taxable income of $165,000 for 1987 and $200,000 for 1988. This adjustment results in underpayments for 1987 and 1988 that are attributable to the disregard of rules or regulations on the 1990 return. Therefore, the 20 percent penalty rate applies to the 1987 and 1988 underpayments attributable to the disallowed carryback.

[T.D. 8381, 56 FR 67498, Dec. 31, 1991, as amended by T.D. 8617, 60 FR 45664, Sept. 1, 1995; T.D. 8790, 63 FR 66434, Dec. 2, 1998; T.D. 9109, 68 FR 75127, Dec. 30, 2003]

§ 1.6662–4 Substantial understatement of income tax.

(a) *In general*. If any portion of an underpayment, as defined in section 6664(a) and §1.6664–2, of any income tax imposed under subtitle A of the Code that is required to be shown on a return is attributable to a substantial understatement of such income tax, there is added to the tax an amount equal to 20 percent of such portion. Except in the case of any item attributable to a tax shelter (as defined in paragraph (g)(2) of this section), an understatement is reduced by the portion of the understatement that is attributable to the tax treatment of an item for which there is substantial authority, or with respect to which there is adequate disclosure. General rules for determining the amount of an understatement are set forth in paragraph (b) of this section and more specific rules in the case of carrybacks and carryovers are set forth in paragraph (c) of this section. The rules for determining when substantial authority exists are set forth in §1.6662–4(d). The rules for determining when there is adequate disclosure are set forth in §1.6662–4 (e) and (f). This penalty does not apply to the extent that the reasonable cause and good faith exception to this penalty set forth in §1.6664–4 applies.

(b) *Definitions and computational rules*—(1) *Substantial*. An understatement (as defined in paragraph (b)(2) of this section) is ''substantial'' if it exceeds the greater of—

(i) 10 percent of the tax required to be shown on the return for the taxable year (as defined in paragraph (b)(3) of this section); or

(ii) $5,000 ($10,000 in the case of a corporation other than an S corporation (as defined in section 1361(a)(1)) or a personal holding company (as defined in section 542)).

(2) *Understatement*. Except as provided in paragraph (c)(2) of this section

(relating to special rules for carrybacks), the term ''understatement'' means the excess of—

(i) The amount of the tax required to be shown on the return for the taxable year (as defined in paragraph (b)(3) of this section), over

(ii) The amount of the tax imposed which is shown on the return for the taxable year (as defined in paragraph (b)(4) of this section), reduced by any rebate (as defined in paragraph (b)(5) of this section).

The definition of understatement also may be expressed as—

Understatement = X − (Y − Z)

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

(3) *Amount of the tax required to be shown on the return.* The ''amount of the tax required to be shown on the return'' for the taxable year has the same meaning as the ''amount of income tax imposed'' as defined in §1.6664–2(b).

(4) *Amount of the tax imposed which is shown on the return.* The ''amount of the tax imposed which is shown on the return'' for the taxable year has the same meaning as the ''amount shown as the tax by the taxpayer on his return,'' as defined in §1.6664–2(c), except that—

(i) There is no reduction for the excess of the amount described in §1.6664–2(c)(1)(i) over the amount described in §1.6664–2(c)(1)(ii), and

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

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

(B) Items (other than tax shelter items as defined in §1.6662–4(g)(3)) with respect to which there is adequate disclosure (as provided in §1.6662–4 (e) and (f)).

(C) Tax shelter items (as defined in §1.6662–4(g)(3)) for which there is substantial authority for the treatment claimed (as provided in §1.6662–4(d)), and with respect to which the taxpayer reasonably believed that the tax treatment of the items was more likely than not the proper tax treatment (as provided in §1.6662–4(g)(4)).

(5) *Rebate.* The term *rebate* has the meaning set forth in §1.6664–2(e), except that—

(i) ''Amounts not so shown previously assessed (or collected without assessment)'' includes only amounts not so shown previously assessed (or collected without assessment) as a deficiency, and

(ii) The amount of the rebate is determined as if any items to which the rebate is attributable that are described in paragraph (b)(4) of this section had received the proper tax treatment.

(6) *Examples.* The following examples illustrate the provisions of paragraph (b) of this section. These examples do not take into account the reasonable cause exception under §1.6664–4:

Example 1. In 1990, Individual A, a calendar year taxpayer, files a return for 1989, which shows taxable income of $18,200 and tax liability of $2,734. Subsequent adjustments on audit for 1989 increase taxable income to $51,500 and tax liability to $12,339. There was substantial authority for an item resulting in an adjustment that increases taxable income by $5,300. The item is not a tax shelter item. In computing the amount of the understatement, the amount of tax shown on A's return is determined as if the item for which there was substantial authority had been given the proper tax treatment. Thus, the amount of tax that is treated as shown on A's return is $4,176, i.e., the tax on $23,500 ($18,200 taxable income actually shown on A's return plus $5,300, the amount of the adjustment for which there was substantial authority). The amount of the understatement is $8,163, i.e., $12,339 (the amount of tax required to be shown) less $4,176 (the amount of tax treated as shown on A's return after adjustment for the item for which there was substantial authority). Because the $8,163 understatement exceeds the greater of 10 percent of the tax required to be shown on the return for the year, i.e., $1,234 ($12,339 × .10) or $5,000, A has a substantial understatement of income tax for the year.

Example 2. Individual B, a calendar year taxpayer, files a return for 1990 that fails to include income reported on an information return, Form 1099, that was furnished to B. The Service detects this omission through its document matching program and assesses $3,000 in unreported tax liability. B's return is later examined and as a result of the examination the Service makes an adjustment to B's return of $4,000 in additional tax liability. Assuming there was neither substantial authority nor adequate disclosure with respect to the items adjusted, there is an understatement of $7,000 with respect to B's return. There is also an underpayment of $7,000. (See §1.6664–2.) The amount of the understatement is not reduced by imposition of a negligence penalty on the $3,000 portion of the underpayment that is attributable to the unreported income. However, if the Services does impose the negligence penalty on this $3,000 portion, the Service may only impose the substantial understatement penalty on the remaining $4,000 portion of the underpayment. (See §1.6662–2(c), which prohibits stacking of accuracy-related penalty components.)

(c) *Special rules in the case of carrybacks and carryovers*—(1) *In general.* The penalty for a substantial understatement of income tax applies to any portion of an underpayment for a year to which a loss, deduction or credit is carried that is attributable to a "tainted item" for the year in which the carryback or carryover of the loss, deduction or credit arises (the "loss or credit year"). The determination of whether an understatement is substantial for a carryback or carryover year is made with respect to the return of the carryback or carryover year. "Tainted items" are taken into account with items arising in a carryback or carryover year to determine whether the understatement is substantial for that year.

(2) *Understatements for carryback years not reduced by amount of carrybacks.* The amount of an understatement for a carryback year is not reduced on account of a carryback of a loss, deduction or credit to that year.

(3) *Tainted items defined*—(i) *In general.* Except in the case of a tax shelter item (as defined in paragraph (g)(3) of this section), a "tainted item" is any item for which there is neither substantial authority nor adequate disclosure with respect to the loss or credit year.

(ii) *Tax shelter items.* In the case of a tax shelter item (as defined in paragraph (g)(3) of this section), a "tainted item" is any item for which there is not, with respect to the loss or credit year, both substantial authority and a reasonable belief that the tax treatment is more likely than not the proper treatment.

(4) *Transition rule for carrybacks to pre-1990 years.* A 20 percent penalty under section 6662(b)(2) is imposed on any portion of an underpayment for a carryback year, the return for which is due (without regard to extensions) before January 1, 1990, if—

(i) That portion is attributable to one or more "tainted items" (as defined in paragraph (c)(3) of this section) arising in a loss or credit year; and

(ii) The return for the loss or credit year is due (without regard to extensions) after December 31, 1989.

The preceding sentence applies only if the understatement in the carryback year is substantial. See *Example 2* in paragraph (c)(5) of this section.

(5) *Examples.* The following examples illustrate the rules of paragraph (c) of this section regarding carrybacks and carryovers. These examples do not take into account the reasonable cause exception under §1.6664–4.

Example 1. (i) Corporation N, a calendar year taxpayer, is a C corporation. N was formed on January 1, 1987, and timely filed the following income tax returns:

[In dollars]

	Tax Year			
	1987	1988	1989	1990 (before NOLCO)
Taxable income	30,000	100,000	(300,000)	50,000
Tax liability	4,575	22,250	....	7,500

(ii) During 1990, N files Form 1139, Corporation Application for Tentative Refund, to carry back the NOL generated in 1989 (NOLCB). N received refunds of $4,575 for 1987 and $22,250 for 1988.

(iii) For tax year 1990, N carries over $50,000 of the 1989 loss to offset $50,000 of income earned in 1990 and reduce taxable income to zero. N would have reported $7,500 of tax liability for 1990 if it were not for use of the net operating loss carryover (NOLCO). N assumes there is a remaining NOLCO of $120,000 to be applied for tax year 1991.

(iv) In June 1991, the Service completes its examination of the 1989 loss year return and makes the following adjustment:

Taxable income per 1989 return	($300,000)
Adjustment: Unreported income	310,000
Corrected taxable income	$10,000
Corrected tax liability	$1,500

(v) There was not substantial authority for N's treatment of the items comprising the 1989 adjustment and N did not make adequate disclosure.

(vi) As a result of the adjustment to the 1989 return, N had an understatement of $4,575 for tax year 1987; an understatement of $22,250 for tax year 1988; an understatement of $1,500 for tax year 1989; and an understatement of $7,500 for tax year 1990. Only the $22,250 understatement for 1988 is a substantial understatement, i.e., it exceeds the greater of (a) $2,225 (10 percent of the tax required to be shown on the return for the taxable year (.10 X $22,250)) or (b) $10,000. The underpayment for 1988 is subject to a penalty rate of 20 percent.

Example 2. The facts are the same as in *Example 1,* except that in addition to examining the 1989 return, the Service also examines the 1987 return and makes an adjustment that results in an understatement. (This adjustment is unrelated to the adjustment on the 1987 return for the disallowance of the NOLCB from 1989.) If the understatement resulting from the adjustment to the 1987 return, when combined with the understatement resulting from the disallowance of the NOLCB from 1989, exceeds the greater of (a) 10 percent of the tax required to be shown on the return for 1987 or (b) $10,000, the underpayment for 1987 will also be subject to a substantial understatement penalty. The portion of the underpayment attributable to the adjustment unrelated to the disallowance of the NOLCB will be subject to a penalty rate of 25 percent under former section 6661. The portion of the underpayment attributable to the disallowance of the NOLCB will be subject to a penalty rate of 20 percent under section 6662.

Example 3. Individual P, a calendar year single taxpayer, files his 1990 return reporting taxable income of $10,000 and a tax liability of $1,504. An examination of the 1990 return results in an adjustment for unreported income of $25,000. There was not substantial authority for P's failure to report the income, and P did not make adequate disclosure with respect to the unreported income. P's correct tax liability for 1990 is determined to be $7,279, resulting in an understatement of $5,775 (the difference between the amount of tax required to be shown on the return ($7,279) and the tax shown on the return ($1,504)). Because the understatement exceeds the greater of (a) $728 (10 percent of the tax required to be shown on the return (.10 × $7,279)) or (b) $5,000, the understatement is substantial. Subsequently, P files his 1993 return showing a net operating loss. The loss is carried back to his 1990 return, reducing his taxable income for 1990 to zero. However, the amount of the understatement for 1990 is not reduced on account of the NOLCB to that year. P is subject to the 20 percent penalty rate under section 6662 on the underpayment attributable to the substantial understatement for 1990, notwithstanding that the tax required to be shown on the return for that year, after application of the NOLCB, is zero.

(d) *Substantial authority*—(1) *Effect of having substantial authority.* If there is substantial authority for the tax treatment of an item, the item is treated as if it were shown properly on the return for the taxable year in computing the amount of the tax shown on the return. Thus, for purposes of section 6662(d), the tax attributable to the item is not included in the understatement for that year. (For special rules relating to tax shelter items see §1.6662–4(g).)

(2) *Substantial authority standard.* The substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts. The substantial authority standard is less stringent than the more likely than not standard (the standard that is met when there is a greater than 50-percent likelihood of the position being upheld), but more stringent than the reasonable basis standard as defined in §1.6662–3(b)(3). The possibility that a return will not be audited or, if audited, that an item will not be raised on audit, is not relevant in determining whether the substantial authority standard (or the reasonable basis standard) is satisfied.

(3) *Determination of whether substantial authority is present*—(i) *Evaluation of authorities.* There is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists. The weight of authorities is determined in light of the pertinent facts and circumstances in the manner prescribed by paragraph (d)(3)(ii) of this section. There may be substantial authority for more than one position with respect to the same item. Because the substantial authority standard is an objective standard, the taxpayer's belief that there is substantial authority for the tax treatment of an item is

not relevant in determining whether there is substantial authority for that treatment.

(ii) *Nature of analysis.* The weight accorded an authority depends on its relevance and persuasiveness, and the type of document providing the authority. For example, a case or revenue ruling having some facts in common with the tax treatment at issue is not particularly relevant if the authority is materially distinguishable on its facts, or is otherwise inapplicable to the tax treatment at issue. An authority that merely states a conclusion ordinarily is less persuasive than one that reaches its conclusion by cogently relating the applicable law to pertinent facts. The weight of an authority from which information has been deleted, such as a private letter ruling, is diminished to the extent that the deleted information may have affected the authority's conclusions. The type of document also must be considered. For example, a revenue ruling is accorded greater weight than a private letter ruling addressing the same issue. An older private letter ruling, technical advice memorandum, general counsel memorandum or action on decision generally must be accorded less weight than a more recent one. Any document described in the preceding sentence that is more than 10 years old generally is accorded very little weight. However, the persuasiveness and relevance of a document, viewed in light of subsequent developments, should be taken into account along with the age of the document. There may be substantial authority for the tax treatment of an item despite the absence of certain types of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision.

(iii) *Types of authority.* Except in cases described in paragraph (d)(3)(iv) of this section concerning written determinations, only the following are authority for purposes of determining whether there is substantial authority for the tax treatment of an item: Applicable 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. Conclusions reached in treatises, legal periodicals, legal opinions or opinions rendered by tax professionals are not authority. The authorities underlying such expressions of opinion where applicable to the facts of a particular case, however, may give rise to substantial authority for the tax treatment of an item. Notwithstanding the preceding list of authorities, an authority does not continue to be an authority to the extent it is overruled or modified, implicitly or explicitly, by a body with the power to overrule or modify the earlier authority. In the case of court decisions, for example, a district court opinion on an issue is not an authority if overruled or reversed by the United States Court of Appeals for such district. However, a Tax Court opinion is not considered to be overruled or modified by a court of appeals to which a taxpayer does not have a right of appeal, unless the Tax Court adopts the holding of the court of appeals. Similarly, a private letter ruling is not authority if revoked or if inconsistent with a subsequent proposed regulation, revenue ruling or other administrative pronouncement published in the Internal Revenue Bulletin.

(iv) *Special rules*—(A) *Written determinations.* There is substantial authority for the tax treatment of an item by a taxpayer if the treatment is supported by the conclusion of a ruling or a determination letter (as defined in §301.6110–2 (d) and (e)) issued to the taxpayer, by the conclusion of a technical advice memorandum in which the taxpayer is named, or by an affirmative statement in a revenue agent's report with respect to a prior taxable year of the taxpayer ("written determinations"). The preceding sentence does not apply, however, if—

(*1*) There was a misstatement or omission of a material fact or the facts that subsequently develop are materially different from the facts on which the written determination was based, or

(*2*) The written determination was modified or revoked after the date of issuance by—

(*i*) A notice to the taxpayer to whom the written determination was issued,

(*ii*) The enactment of legislation or ratification of a tax treaty,

(*iii*) A decision of the United States Supreme Court,

(*iv*) The issuance of temporary or final regulations, or

(*v*) The issuance of a revenue ruling, revenue procedure, or other statement published in the Internal Revenue Bulletin.

Except in the case of a written determination that is modified or revoked on account of §1.6662–4(d)(3)(iv)(A)(*1*), a written determination that is modified or revoked as described in §1.6662–4(d)(3)(iv)(A)(*2*) ceases to be authority on the date, and to the extent, it is so modified or revoked. See section 6404(f) for rules which require the Secretary to abate a penalty that is attributable to erroneous written advice furnished to a taxpayer by an officer or employee of the Internal Revenue Service.

(B) *Taxpayer's jurisdiction.* The applicability of court cases to the taxpayer by reason of the taxpayer's residence in a particular jurisdiction is not taken into account in determining whether there is substantial authority for the tax treatment of an item. Notwithstanding the preceding sentence, there is substantial authority for the tax treatment of an item if the treatment is supported by controlling precedent of a United States Court of Appeals to which the taxpayer has a right of appeal with respect to the item.

(C) *When substantial authority determined.* There is substantial authority for the tax treatment of an item if there is substantial authority at the time the return containing the item is filed or there was substantial authority on the last day of the taxable year to which the return relates.

(v) *Substantial authority for tax returns due before January 1, 1990.* There is substantial authority for the tax treatment of an item on a return that is due (without regard to extensions) after December 31, 1982 and before January 1, 1990, if there is substantial authority for such treatment under either the provisions of paragraph (d)(3)(iii) of this section (which set forth an expanded list of authorities) or of §1.6661–3(b)(2) (which set forth a narrower list of authorities). Under either list of authorities, authorities both for and against the position must be taken into account.

(e) *Disclosure of certain information*—(1) *Effect of adequate disclosure.* Items for which there is adequate disclosure as provided in this paragraph (e) and in paragraph (f) of this section are treated as if such items were shown properly on the return for the taxable year in computing the amount of the tax shown on the return. Thus, for purposes of section 6662(d), the tax attributable to such items is not included in the understatement for that year.

(2) *Circumstances where disclosure will not have an effect.* The rules of paragraph (e)(1) of this section do not apply where the item or position on the return—

(i) Does not have a reasonable basis (as defined in §1.6662–3(b)(3));

(ii) Is attributable to a tax shelter (as defined in section 6662(d)(2)(C)(iii) and paragraph (g)(2) of this section); or

(iii) Is not properly substantiated, or the taxpayer failed to keep adequate books and records with respect to the item or position.

(3) *Restriction for corporations.* For purposes of paragraph (e)(2)(i) of this section, a corporation will not be treated as having a reasonable basis for its tax treatment of an item attributable to a multi-party financing transaction entered into after August 5, 1997, if the

treatment does not clearly reflect the income of the corporation.

(f) *Method of making adequate disclosure*—(1) *Disclosure statement.* Disclosure is adequate with respect to an item (or group of similar items, such as amounts paid or incurred for supplies by a taxpayer engaged in business) or a position on a return if the disclosure is made on a properly completed form attached to the return or to a qualified amended return (as defined in §1.6664–2(c)(3)) for the taxable year. In the case of an item or position other than one that is contrary to a regulation, disclosure must be made on Form 8275 (Disclosure Statement); in the case of a position contrary to a regulation, disclosure must be made on Form 8275–R (Regulation Disclosure Statement).

(2) *Disclosure on return.* The Commissioner may by annual revenue procedure (or otherwise) prescribe the circumstances under which disclosure of information on a return (or qualified amended return) in accordance with applicable forms and instructions is adequate. If the revenue procedure does not include an item, disclosure is adequate with respect to that item only if made on a properly completed Form 8275 or 8275–R, as appropriate, attached to the return for the year or to a qualified amended return.

(3) *Recurring item.* Disclosure with respect to a recurring item, such as the basis of recovery property, must be made for each taxable year in which the item is taken into account.

(4) *Carrybacks and carryovers.* Disclosure is adequate with respect to an item which is included in any loss, deduction or credit that is carried to another year only if made in connection with the return (or qualified amended return) for the taxable year in which the carryback or carryover arises (the ''loss or credit year''). Disclosure is not also required in connection with the return for the taxable year in which the carryback or carryover is taken into account.

(5) *Pass-through entities.* Disclosure in the case of items attributable to a pass-through entity (pass-through items) is made with respect to the return of the entity, except as provided in this paragraph (f)(5). Thus, disclosure in the case of pass-through items must be made on a Form 8275 or 8275–R, as appropriate, attached to the return (or qualified amended return) of the entity, or on the entity's return in accordance with the revenue procedure described in paragraph (f)(2) of this section, if applicable. A taxpayer (i.e., partner, shareholder, beneficiary, or holder of a residual interest in a REMIC) also may make adequate disclosure with respect to a pass-through item, however, if the taxpayer files a properly completed Form 8275 or 8275–R, as appropriate, in duplicate, one copy attached to the taxpayer's return (or qualified amended return) and the other copy filed with the Internal Revenue Service Center with which the return of the entity is required to be filed. Each Form 8275 or 8275–R, as appropriate, filed by the taxpayer should relate to the pass-through items of only one entity. For purposes of this paragraph (f)(5), a pass-through entity is a partnership, S corporation (as defined in section 1361(a)(1)), estate, trust, regulated investment company (as defined in section 851(a)), real estate investment trust (as defined in section 856(a)), or real estate mortgage investment conduit (''REMIC'') (as defined in section 860D(a)).

(g) *Items relating to tax shelters*—(1) *In general*—(i) *Noncorporate taxpayers.* Tax shelter items (as defined in paragraph (g)(3) of this section) of a taxpayer other than a corporation are treated for purposes of this section as if such items were shown properly on the return for a taxable year in computing the amount of tax shown on the return, and thus the tax attributable to such items is not included in the understatement for the year, if—

(A) There is substantial authority (as provided in paragraph (d) of this section) for the tax treatment of that item; and

(B) The taxpayer reasonably believed at the time the return was filed that the tax treatment of that item was more likely than not the proper treatment.

(ii) *Corporate taxpayers*—(A) *In general.* Except as provided in paragraph (g)(1)(ii)(B) of this section, all tax shelter items (as defined in paragraph (g)(3) of this section) of a corporation are taken into account in computing the amount of any understatement.

(B) *Special rule for transactions occurring prior to December 9, 1994.* The tax shelter items of a corporation arising in connection with transactions occurring prior to December 9, 1994 are treated for purposes of this section as if such items were shown properly on the return if the requirements of paragraph (g)(1)(i) are satisfied with respect to such items.

(iii) *Disclosure irrelevant.* Disclosure made with respect to a tax shelter item of either a corporate or noncorporate taxpayer does not affect the amount of an understatement.

(iv) *Cross-reference.* See §1.6664–4(f) for certain rules regarding the availability of the reasonable cause and good faith exception to the substantial understatement penalty with respect to tax shelter items of corporations.

(2) *Tax shelter*—(i) *In general.* For purposes of section 6662(d), the term ''tax shelter'' means—

(A) A partnership or other entity (such as a corporation or trust),

(B) An investment plan or arrangement, or

(C) Any other plan or arrangement,

if the principal purpose of the entity, plan or arrangement, based on objective evidence, is to avoid or evade Federal income tax. The principal purpose of an entity, plan or arrangement is to avoid or evade Federal income tax if that purpose exceeds any other purpose. Typical of tax shelters are transactions structured with little or no motive for the realization of economic gain, and transactions that utilize the mismatching of income and deductions, overvalued assets or assets with values subject to substantial uncertainty, certain nonrecourse financing, financing techniques that do not conform to standard commercial business practices, or the mischaracterization of the substance of the transaction. The existence of economic substance does not of itself establish that a transaction is not a tax shelter if the transaction includes other characteristics that indicate it is a tax shelter.

(ii) *Principal purpose.* The principal purpose of an entity, plan or arrangement is not to avoid or evade Federal income tax if the entity, plan or arrangement has as its purpose the claiming of exclusions from income, accelerated deductions or other tax benefits in a manner consistent with the statute and Congressional purpose. For example, an entity, plan or arrangement does not have as its principal purpose the avoidance or evasion of Federal income tax solely as a result of the following uses of tax benefits provided by the Internal Revenue Code: the purchasing or holding of an obligation bearing interest that is excluded from gross income under section 103; taking an accelerated depreciation allowance under section 168; taking the percentage depletion allowance under section 613 or section 613A; deducting intangible drilling and development costs as expenses under section 263(c); establishing a qualified retirement plan under sections 401–409; claiming the possession tax credit under section 936; or claiming tax benefits available by reason of an election under 992 to be taxed as a domestic international sales corporation (''DISC''), under section 927(f)(1) to be taxed as a foreign sales corporation (''FSC''), or under section 1362 to be taxed as an S corporation.

(3) *Tax shelter item.* An item of income, gain, loss, deduction or credit is a ''tax shelter item'' if the item is directly or indirectly attributable to the principal purpose of a tax shelter to avoid or evade Federal income tax. Thus, if a partnership is established for the principal purpose of avoiding or evading Federal income tax by acquiring and overstating the basis of property for purposes of claiming accelerated depreciation, the depreciation with respect to the property is a tax shelter item. However, a deduction claimed in connection with a separate transaction carried on by the same partnership is not a tax shelter item if the transaction does not constitute a plan or arrangement the principal purpose of which is to avoid or evade tax.

(4) *Reasonable belief*—(i) *In general.* For purposes of section 6662(d) and paragraph (g)(1)(i)(B) of this section (pertaining to tax shelter items of noncorporate taxpayers), a taxpayer is considered reasonably to believe that the tax treatment of an item is more likely than not the proper tax treatment if (without taking into account

the possibility that a return will not be audited, that an issue will not be raised on audit, or that an issue will be settled)—

(A) The taxpayer analyzes the pertinent facts and authorities in the manner described in paragraph (d)(3)(ii) of this section, and in reliance upon that analysis, reasonably concludes in good faith that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service; or

(B) The taxpayer reasonably relies in good faith on the opinion of a professional tax advisor, if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities in the manner described in paragraph (d)(3)(ii) of this section and unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service.

(ii) *Facts and circumstances; reliance on professional tax advisor*. All facts and circumstances must be taken into account in determining whether a taxpayer satisfies the requirements of paragraph (g)(4)(i) of this section. However, in no event will a taxpayer be considered to have reasonably relied in good faith on the opinion of a professional tax advisor for purposes of paragraph (g)(4)(i)(B) of this section unless the requirements of § 1.6664–4(c)(1) are met. The fact that the requirements of § 1.6664–4(c)(1) are satisfied will not necessarily establish that the taxpayer reasonably relied on the opinion in good faith. For example, reliance may not be reasonable or in good faith if the taxpayer knew, or should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.

(5) *Pass-through entities*. In the case of tax shelter items attributable to a pass-through entity, the actions described in paragraphs (g)(4)(i)(A) and (B) of this section, if taken by the entity, are deemed to have been taken by the taxpayer and are considered in determining whether the taxpayer reasonably believed that the tax treatment of an item was more likely than not the proper tax treatment.

[T.D. 8381, 56 FR 67499, Dec. 31, 1991; T.D. 8381, 57 FR 6165, Feb. 20, 1992, as amended by T.D. 8617, 60 FR 45665, Sept. 1, 1995; T.D. 8790, 63 FR 66435, Dec. 2, 1998; T.D. 9109, 68 FR 75128, Dec. 30, 2003]

§ 1.6662–5 Substantial and gross valuation misstatements under chapter 1.

(a) *In general*. If any portion of an underpayment, as defined in section 6664(a) and § 1.6664–2, of any income tax imposed under chapter 1 of subtitle A of the Code that is required to be shown on a return is attributable to a substantial valuation misstatement under chapter 1 (''substantial valuation misstatement''), there is added to the tax an amount equal to 20 percent of such portion. Section 6662(h) increases the penalty to 40 percent in the case of a gross valuation misstatement under chapter 1 (''gross valuation misstatement''). No penalty under section 6662(b)(3) is imposed, however, on a portion of an underpayment that is attributable to a substantial or gross valuation misstatement unless the aggregate of all portions of the underpayment attributable to substantial or gross valuation misstatements exceeds the applicable dollar limitation ($5,000 or $10,000), as provided in section 6662(e)(2) and paragraphs (b) and (f)(2) of this section. This penalty also does not apply to the extent that the reasonable cause and good faith exception to this penalty set forth in § 1.6664–4 applies. There is no disclosure exception to this penalty.

(b) *Dollar limitation*. No penalty may be imposed under section 6662(b)(3) for a taxable year unless the portion of the underpayment for that year that is attributable to substantial or gross valuation misstatements exceeds $5,000 ($10,000 in the case of a corporation other than an S corporation (as defined in section 1361(a)(1)) or a personal holding company (as defined in section 542)). This limitation is applied separately to each taxable year for which there is a substantial or gross valuation misstatement.

(c) *Special rules in the case of carrybacks and carryovers*—(1) *In general*. The penalty for a substantial or gross valuation misstatement applies to any portion of an underpayment for a year to which a loss, deduction or credit is carried that is attributable to a substantial or gross valuation misstatement for the year in which the carryback or carryover of the loss, deduction or credit arises (the ''loss or credit year''), provided that the applicable dollar limitation set forth in section 6662(e)(2) is satisfied in the carryback or carryover year.

(2) *Transition rule for carrybacks to pre-1990 years.* The penalty under section 6662(b)(3) is imposed on any portion of an underpayment for a carryback year, the return for which is due (without regard to extensions) before January 1, 1990, if—

(i) That portion is attributable to a substantial or gross valuation misstatement for a loss or credit year; and

(ii) The return for the loss or credit year is due (without regard to extensions) after December 31, 1989.

The preceding sentence applies only if the underpayment for the carryback year exceeds the applicable dollar limitation ($5,000, or $10,000 for most corporations). See *Example 3* in paragraph (d) of this section.

(d) *Examples.* The following examples illustrate the provisions of paragraphs (b) and (c) of this section. These examples do not take into account the reasonable cause exception under §1.6664–4.

Example 1. Corporation Q is a C corporation. In 1990, the first year of its existence, Q had taxable income of $200,000 without considering depreciation of a particular asset. On its calendar year 1990 return, Q overstated its basis in this asset by an amount that caused a substantial valuation misstatement. The overstated basis resulted in depreciation claimed of $350,000, which was $250,000 more than the $100,000 allowable. Thus, on its 1990 return, Q showed a loss of $150,000. In 1991, Q had taxable income of $450,000 before application of the loss carryover, and Q claimed a carryover loss deduction under section 172 of $150,000, resulting in taxable income of $300,000 for 1991. Upon audit of the 1990 return, the basis of the asset was corrected, resulting in an adjustment of $250,000. For 1990, the underpayment resulting from the $100,000 taxable income (−$150,000+$250,000) is attributable to the valuation misstatement. Assuming the underpayment resulting from the $100,000 taxable income exceeds the $10,000 limitation, the penalty will be imposed in 1990. For 1991, the elimination of the loss carryover results in additional taxable income of $150,000. The underpayment for 1991 resulting from that adjustment is also attributable to the substantial valuation misstatement on the 1990 return. Assuming the underpayment resulting from the $150,000 additional taxable income for 1991 exceeds the $10,000 limitation, the substantial valuation misstatement penalty also will be imposed for that year.

Example 2. (i) Corporation T is a C corporation. In 1990, the first year of its existence, T had a loss of $3,000,000 without considering depreciation of its major asset. On its calendar year 1990 return, T overstated its basis in this asset in an amount that caused a substantial valuation misstatement. This overstatement resulted in depreciation claimed of $3,500,000, which was $2,500,000 more than the $1,000,000 allowable. Thus, on its 1990 return, T showed a loss of $6,500,000. In 1991, T had taxable income of $4,500,000 before application of the carryover loss, but claimed a carryover loss deduction under section 172 in the amount of $4,500,000, resulting in taxable income of zero for that year and leaving a $2,000,000 carryover available. Upon audit of the 1990 return, the basis of the asset was corrected, resulting in an adjustment of $2,500,000.

(ii) For 1990, the underpayment is still zero (−$6,500,000+$2,500,000=−$4,000,000). Thus, the penalty does not apply in 1990. The loss for 1990 is reduced to $4,000,000.

(iii) For 1991, there is additional taxable income of $500,000 as a result of the reduction of the carryover loss ($4,500,000 reported income before carryover loss minus corrected carryover loss of $4,000,000=$500,000). The underpayment for 1991 resulting from reduction of the carryover loss is attributable to the valuation misstatement on the 1990 return. Assuming the underpayment resulting from the $500,000 additional taxable income exceeds the $10,000 limitation, the substantial valuation misstatement penalty will be imposed in 1991.

Example 3. Corporation V is a C corporation. In 1990, V had a loss of $100,000 without considering depreciation of a particular asset which it had fully depreciated in earlier years. V had a depreciable basis in the asset of zero, but on its 1990 calendar year return erroneously claimed a basis in the asset of $1,250,000 and depreciation of $250,000. V reported a $350,000 loss for the year 1990, and carried back the loss to the 1987 and 1988 tax years. V had reported taxable income of $300,000 in 1987 and $200,000 in 1988, before application of the carryback. The $350,000 carryback eliminated all taxable income for 1987, and $50,000 of the taxable income for 1988. After disallowance of the $250,000 depreciation deduction for 1990, V still had a loss of $100,000. Because there is no underpayment for 1990, no valuation misstatement penalty is imposed for 1990. However, as a result of the 1990 depreciation adjustment, the carryback to 1987 is reduced from $350,000 to $100,000. After absorption of the $100,000 carryback, V has taxable income of $200,000 for 1987. This adjustment results in an underpayment for 1987 that is attributable to the valuation misstatement on the 1990 return. The valuation misstatement for 1990 is a gross valuation misstatement because the correct adjusted basis of the depreciated asset was zero. (See paragraph (e)(2) of this section.) Therefore, the 40 percent penalty rate applies to the 1987 underpayment attributable to the 1990 misstatement, provided that this underpayment exceeds $10,000. The adjustment also results in the elimination of any loss carryback to 1988 resulting in an increase in taxable income for 1988 of $50,000. Assuming the underpayment resulting from this additional $50,000 of income exceeds $10,000, the gross valuation misstatement penalty is imposed on the underpayment for 1988.

(e) *Definitions*—(1) *Substantial valuation misstatement.* There is a substantial valuation misstatement if the value or adjusted basis of any property claimed on a return of tax imposed under chapter 1 is 200 percent or more of the correct amount.

(2) *Gross valuation misstatement.* There is a gross valuation misstatement if the value or adjusted basis of any property claimed on a return of tax imposed under chapter 1 is 400 percent or more of the correct amount.

(3) *Property.* For purposes of this section, the term ''property'' refers to both tangible and intangible property. Tangible property includes property such as land, buildings, fixtures and inventory. Intangible property includes property such as goodwill, covenants not to compete, leaseholds, patents, contract rights, debts and choses in action.

(f) *Multiple valuation misstatements on a return*—(1) *Determination of whether valuation misstatements are substantial or gross.* The determination of whether there is a substantial or gross valuation misstatement on a return is made on a property-by-property basis. Assume, for example, that property A has a value of 60 but a taxpayer claims a value of 110, and that property B has a value of 40 but the taxpayer claims a value of 100. Because the claimed and correct values are compared on a property-by-property basis, there is a substantial valuation misstatement with respect to property B, but not with respect to property A, even though the claimed values (210) are 200 percent or more of the correct values (100) when compared on an aggregate basis.

(2) *Application of dollar limitation.* For purposes of applying the dollar limitation set forth in section 6662(e)(2), the determination of the portion of an underpayment that is attributable to a substantial or gross valuation misstatement is made by aggregating all portions of the underpayment attributable to substantial or gross valuation misstatements. Assume, for example, that the value claimed for property C on a return is 250 percent of the correct value, and that the value claimed for property D on the return is 400 percent of the correct value. Because the portions of an underpayment that are attributable to a substantial or gross valuation misstatement on a return are aggregated in applying the dollar limitation, the dollar limitation is satisfied if the portion of the underpayment that is attributable to the misstatement of the value of property C, when aggregated with the portion of the underpayment that is attributable to the misstatement of the value of property D, exceeds $5,000 ($10,000 in the case of most corporations).

(g) *Property with a value or adjusted basis of zero.* The value or adjusted basis claimed on a return of any property with a correct value or adjusted basis of zero is considered to be 400 percent or more of the correct amount. There is a gross valuation misstatement with respect to such property, therefore, and the applicable penalty rate is 40 percent.

(h) *Pass-through entities*—(1) *In general.* The determination of whether there is a substantial or gross valuation misstatement in the case of a return of a pass-through entity (as defined in §1.6662–4(f)(5)) is made at the entity level. However, the dollar limitation ($5,000 or $10,000, as the case may be) is applied at the taxpayer level (*i.e.*, with respect to the return of the shareholder, partner, beneficiary, or holder of a residual interest in a REMIC).

(2) *Example.* The rules of paragraph (h)(1) of this section may be illustrated by the following example.

Example. Partnership P has two partners, individuals A and B. P claims a $40,000 basis in a depreciable asset which, in fact, has a basis of $15,000. The determination that there is a substantial valuation misstatement is made solely with reference to P by comparing the $40,000 basis claimed by P with P's correct basis of $15,000. However, the determination of whether the $5,000 threshold for application of the penalty has been reached is made separately for each partner. With respect to partner A, the penalty will apply if the portion of A's underpayment attributable to the passthrough of the depreciation deduction, when aggregated with any other portions of A's underpayment also attributable to substantial or gross valuation misstatements, exceeds $5,000 (assuming there is not reasonable cause for the misstatements (*see* § 1.6664–4(c)).

(i) [Reserved]

(j) *Transactions between persons described in section 482 and net section 482 transfer price adjustments.* [Reserved]

(k) *Returns affected.* Except in the case of rules relating to transactions between persons described in section 482 and net sections 482 transfer price adjustments, the provisions of section 6662(b)(3) apply to returns due (without regard to extensions of time to file) after December 31, 1989, notwithstanding that the original substantial or gross valuation misstatement occurred on a return that was due (without regard to extensions) before January 1, 1990. Assume, for example, that a calendar year corporation claimed a deduction on its 1990 return for depreciation of an asset with a basis of X. Also assume that it had reported the same basis for computing depreciation on its returns for the preceding 5 years and that the basis shown on the return each year was 200 percent or more of the correct basis. The corporation may be subject to a penalty for substantial valuation misstatements on its 1989 and 1990 returns, even though the original misstatement occurred prior to the effective date of sections 6662(b)(3) and (e).

[T.D. 8381, 56 FR 67504, Dec. 31, 1991; T.D. 8381, 57 FR 6165, Feb. 20, 1992]

§ 1.6662–5T Substantial and gross valuation misstatements under chapter 1 (temporary).

(a)–(e)(3) [Reserved]. For further information, see § 1.6662–5(a) through (e)(3).

(e)(4) *Tests related to section 482*—(i) *Substantial valuation misstatement.* There is a substantial valuation misstatement if there is a misstatement described in § 1.6662–6 (b)(1) or (c)(1) (concerning substantial valuation misstatements pertaining to transactions between related persons).

(ii) *Gross valuation misstatement.* There is a gross valuation misstatement if there is a misstatement described in § 1.6662–6 (b)(2) or (c)(2) (concerning gross valuation misstatements pertaining to transactions between related persons).

(iii) *Property.* For purposes of this section, the term *property* refers to both tangible and intangible property. Tangible property includes property such as money, land, buildings, fixtures and inventory. Intangible property includes property such as goodwill, covenants not to compete, leaseholds, patents, contract rights, debts, choses in action, and any other item of intangible property described in § 1.482–4(b).

(f)–(h) [Reserved]. For further information, see § 1.6662–5 (f) through (h).

(i) [Reserved]

(j) *Transactions between persons described in section 482 and net section 482 transfer price adjustments.* For rules relating to the penalty imposed with respect to a substantial or gross valuation misstatement arising from a section 482 allocation, see § 1.6662–6.

[T.D. 8656, 61 FR 4879, Feb. 9, 1996; T.D. 8656, 61 FR 14248, Apr. 1, 1996]

§ 1.6662–6 Transactions between persons described in section 482 and net section 482 transfer price adjustments.

(a) *In general*—(1) *Purpose and scope.* Pursuant to section 6662(e) a penalty is imposed on any underpayment attributable to a substantial valuation misstatement pertaining to either a transaction between persons described in section 482 (the transactional penalty) or a net section 482 transfer price adjustment (the net adjustment penalty). The penalty is equal to 20 percent of the underpayment of tax attributable to that substantial valuation misstatement. Pursuant to section 6662(h) the penalty is increased to 40 percent of the underpayment in the case of a gross valuation misstatement with respect to either penalty. Paragraph (b) of this section provides specific rules related to the transactional penalty. Paragraph (c) of this section provides specific rules related to the net adjustment penalty, and paragraph (d) of this section describes amounts that will be excluded for purposes of calculating the net adjustment penalty. Paragraph (e) of this section sets forth special rules in the case of carrybacks and carryovers. Paragraph (f) of this section provides coordination rules between penalties. Paragraph (g) of this section provides the effective date of this section.

(2) *Reported results.* Whether an underpayment is attributable to a substantial or gross valuation misstatement must be determined from the results of controlled transactions that are reported on an income tax return, regardless of whether the amount reported differs from the transaction price initially reflected in the taxpayer's books and records. The results of controlled transactions that are reported on an amended return will be used only if the amended return is filed before the Internal Revenue Service has contacted the taxpayer regarding the corresponding original return. A written statement furnished by a taxpayer subject to the Coordinated Examination Program or a written statement furnished by the taxpayer when electing Accelerated Issue Resolution or similar procedures will be considered an amended return for purposes of this section if it satisfies either the requirements of a qualified amended return for purposes of §1.6664–2(c)(3) or such requirements as the Commissioner may prescribe by revenue procedure. In the case of a taxpayer that is a member of a consolidated group, the rules of this paragraph (a)(2) apply to the consolidated income tax return of the group.

(3) *Identical terms used in the section 482 regulations.* For purposes of this section, the terms used in this section shall have the same meaning as identical terms used in regulations under section 482.

(b) *The transactional penalty*—(1) *Substantial valuation misstatement.* In the case of any transaction between related persons, there is a substantial valuation misstatement if the price for any property or services (or for the use of property) claimed on any return is 200 percent or more (or 50 percent or less) of the amount determined under section 482 to be the correct price.

(2) *Gross valuation misstatement.* In the case of any transaction between related persons, there is a gross valuation misstatement if the price for any property or services (or for the use of property) claimed on any return is 400 percent or more (or 25 percent or less) of the amount determined under section 482 to be the correct price.

(3) *Reasonable cause and good faith.* Pursuant to section 6664(c), the transactional penalty will not be imposed on any portion of an underpayment with respect to which the requirements of §1.6664–4 are met. In applying the provisions of §1.6664–4 in a case in which the taxpayer has relied on professional analysis in determining its transfer pricing, whether the professional is an employee of, or related to, the taxpayer is not determinative in evaluating whether the taxpayer reasonably relied in good faith on advice. A taxpayer that meets the requirements of paragraph (d) of this section with respect to an allocation under section 482 will be treated as having established that there was reasonable cause and good faith with respect to that item for purposes of §1.6664–4. If a substantial or gross valuation misstatement under the transactional penalty also constitutes (or is part of) a substantial or gross valuation misstatement under the net adjustment penalty, then the rules of paragraph (d) of this section (and not the rules of §1.6664–4) will be applied to determine whether the adjustment is excluded from calculation of the net section 482 adjustment.

(c) *Net adjustment penalty*—(1) *Net section 482 adjustment.* For purposes of this section, the term *net section 482 adjustment* means the sum of all increases in the taxable income of a taxpayer for a taxable year resulting from allocations under section 482 (determined without regard to any amount carried to such taxable year from another taxable year) less any decreases in taxable income attributable to collateral adjustments as described in §1.482–1(g). For purposes of this section, amounts that meet the requirements of paragraph (d) of this section will be excluded from the calculation of the net section 482 adjustment. Substantial and gross valuation misstatements that are subject to the transactional penalty under paragraph (b) (1) or (2) of this section are included in determining the amount of the net section 482 adjustment. See paragraph (f) of this section for coordination rules between penalties.

(2) *Substantial valuation misstatement.* There is a substantial valuation misstatement if a net section 482 adjustment is greater than the lesser of 5 million dollars or ten percent of gross receipts.

(3) *Gross valuation misstatement.* There is a gross valuation misstatement if a net section 482 adjustment is greater than the lesser of 20 million dollars or twenty percent of gross receipts.

(4) *Setoff allocation rule.* If a taxpayer meets the requirements of paragraph (d) of this section with respect to some, but not all of the allocations made under section 482, then for purposes of determining the net section 482 adjustment, setoffs, as taken into account under §1.482–1(g)(4), must be applied ratably against all such allocations. The following example illustrates the principle of this paragraph (c)(4):

Example. (i) The Internal Revenue Service makes the following section 482 adjustments for the taxable year:

(1) Attributable to an increase in gross income because of an increase in royalty payments	$9,000,000
(2) Attributable to an increase in sales proceeds due to a decrease in the profit margin of a related buyer	6,000,000
(3) Because of a setoff under §1.482–1(g)(4)	(5,000,000)
Total section 482 adjustments	10,000,000

(ii) The taxpayer meets the requirements of paragraph (d) with respect to adjustment number one, but not with respect to adjustment number two. The five million dollar setoff will be allocated ratably against the nine million dollar adjustment ($9,000,000/$15,000,000×$5,000,000=$3,000,000) and the six million dollar adjustment ($6,000,000/$15,000,000×$5,000,000=$2,000,000). Accordingly, in determining the net section 482 adjustment, the nine million dollar adjustment is reduced to six million dollars ($9,000,000–$3,000,000) and the six million dollar adjustment is reduced to four million dollars ($6,000,000–$2,000,000). Therefore, the net section 482 adjustment equals four million dollars.

(5) *Gross receipts.* For purposes of this section, gross receipts must be computed pursuant to the rules contained in §1.448–1T(f)(2)(iv), as adjusted to reflect allocations under section 482.

(6) *Coordination with reasonable cause exception under section 6664(c).* Pursuant to section 6662(e)(3)(D), a taxpayer will be treated as having reasonable cause under section 6664(c) for any portion of an underpayment attributable to a net section 482 adjustment only if the taxpayer meets the requirements of paragraph (d) of this section with respect to that portion.

(7) *Examples.* The principles of this paragraph (c) are illustrated by the following examples:

Example 1. (i) The Internal Revenue Service makes the following section 482 adjustments for the taxable year:

(1) Attributable to an increase in gross income because of an increase in royalty payments	$2,000,000
(2) Attributable to an increase in sales proceeds due to a decrease in the profit margin of a related buyer	2,500,000
(3) Attributable to a decrease in the cost of goods sold because of a decrease in the cost plus mark-up of a related seller	2,000,000
Total section 482 adjustments	6,500,000

(ii) None of the adjustments are excluded under paragraph (d) of this section. The net section 482 adjustment ($6.5 million) is greater than five million dollars. Therefore, there is a substantial valuation misstatement.

Example 2. (i) The Internal Revenue Service makes the following section 482 adjustments for the taxable year:

(1) Attributable to an increase in gross income because of an increase in royalty payments	$11,000,000
(2) Attributable to an increase in sales proceeds due to a decrease in the profit margin of a related buyer	2,000,000
(3) Because of a setoff under §1.482–1(g)(4)	(9,000,000)
Total section 482 adjustments	4,000,000

(ii) The taxpayer has gross receipts of sixty million dollars after taking into account all section 482 adjustments. None of the adjustments are excluded under paragraph (d) of this section. The net section 482 adjustment

($4 million) is less than the lesser of five million dollars or ten percent of gross receipts ($60 million×10%=$6 million). Therefore, there is no substantial valuation misstatement.

Example 3. (i) The Internal Revenue Service makes the following section 482 adjustments to the income of an affiliated group that files a consolidated return for the taxable year:

(1) Attributable to Member A	$1,500,000
(2) Attributable to Member B	1,000,000
(3) Attributable to Member C	2,000,000
Total section 482 adjustments	4,500,000

(ii) Members A, B, and C have gross receipts of 20 million dollars, 12 million dollars, and 11 million dollars, respectively. Thus, the total gross receipts are 43 million dollars. None of the adjustments are excluded under paragraph (d) of this section. The net section 482 adjustment ($4.5 million) is greater than the lesser of five million dollars or ten percent of gross receipts ($43 million × 10% = $4.3 million). Therefore, there is a substantial valuation misstatement.

Example 4. (i) The Internal Revenue Service makes the following section 482 adjustments to the income of an affiliated group that files a consolidated return for the taxable year:

(1) Attributable to Member A	$1,500,000
(2) Attributable to Member B	3,000,000
(3) Attributable to Member C	2,500,000
Total section 482 adjustments	7,000,000

(ii) Members A, B, and C have gross receipts of 20 million dollars, 35 million dollars, and 40 million dollars, respectively. Thus, the total gross receipts are 95 million dollars. None of the adjustments are excluded under paragraph (d) of this section. The net section 482 adjustment (7 million dollars) is greater than the lesser of five million dollars or ten percent of gross receipts ($95 million × 10% = $9.5 million). Therefore, there is a substantial valuation misstatement.

Example 5. (i) The Internal Revenue Service makes the following section 482 adjustments to the income of an affiliated group that files a consolidated return for the taxable year:

(1) Attributable to Member A	$2,000,000
(2) Attributable to Member B	1,000,000
(3) Attributable to Member C	1,500,000
Total section 482 adjustments	4,500,000

(ii) Members A, B, and C have gross receipts of 10 million dollars, 35 million dollars, and 40 million dollars, respectively. Thus, the total gross receipts are 85 million dollars. None of the adjustments are excluded under paragraph (d) of this section. The net section 482 adjustment ($4.5 million) is less than the lesser of five million dollars or ten percent of gross receipts ($85 million × 10%=$8.5 million). Therefore, there is no substantial valuation misstatement even though individual member A's adjustment ($2 million) is greater than ten percent of its individual gross receipts ($10 million × 10%=$1 million).

(d) *Amounts excluded from net section 482 adjustments*—(1) *In general.* An amount is excluded from the calculation of a net section 482 adjustment if the requirements of paragraph (d) (2), (3), or (4) of this section are met with respect to that amount.

(2) *Application of a specified section 482 method*—(i) *In general.* An amount is excluded from the calculation of a net section 482 adjustment if the taxpayer establishes that both the specified method and documentation requirements of this paragraph (d)(2) are met with respect to that amount. For purposes of this paragraph (d), a method will be considered a specified method if it is described in the regulations under section 482 and the method applies to transactions of the type under review. An unspecified method is not considered a specified method. See §§1.482–3(e) and 1.482–4(d).

(ii) *Specified method requirement.* (A) The specified method requirement is met if the taxpayer selects and applies a specified method in a reasonable manner. The taxpayer's selection and application of a specified method is reasonable only if, given the available data and the applicable pricing methods, the taxpayer reasonably concluded that the method (and its application of that method) provided the most reliable measure of an arm's length result under the principles of the best method rule of §1.482–1(c). A taxpayer can reasonably conclude that a specified method provided the most reliable measure of an arm's length result only if it has made a reasonable effort to evaluate the potential applicability of the other specified methods in a manner consistent with the principles of the best method rule. The extent of this evaluation generally will depend on the nature of the available data, and it may vary from case to case and from method to method. This evaluation may not entail an exhaustive analysis or detailed application of each method. Rather, after a reasonably thorough search for relevant data, the taxpayer should consider which method would provide the most reliable measure of an arm's length result given that data.

The nature of the available data may enable the taxpayer to conclude reasonably that a particular specified method provides a more reliable measure of an arm's length result than one or more of the other specified methods, and accordingly no further consideration of such other specified methods is needed. Further, it is not necessary for a taxpayer to conclude that the selected specified method provides a more reliable measure of an arm's length result than any unspecified method. For examples illustrating the selection of a specified method consistent with this paragraph (d)(2)(ii), see §1.482–8. Whether the taxpayer's conclusion was reasonable must be determined from all the facts and circumstances. The factors relevant to this determination include the following:

(*1*) The experience and knowledge of the taxpayer, including all members of the taxpayer's controlled group.

(*2*) The extent to which reliable data was available and the data was analyzed in a reasonable manner. A taxpayer must engage in a reasonably thorough search for the data necessary to determine which method should be selected and how it should be applied. In determining the scope of a reasonably thorough search for data, the expense of additional efforts to locate new data may be weighed against the likelihood of finding additional data that would improve the reliability of the results and the amount by which any new data would change the taxpayer's taxable income. Furthermore, a taxpayer must use the most current reliable data that is available before the end of the taxable year in question. Although the taxpayer is not required to search for relevant data after the end of the taxable year, the taxpayer must maintain as a principal document described in paragraph (d)(2)(iii)(B)(*9*) of this section any relevant data it obtains after the end of the taxable year but before the return is filed, if that data would help determine whether the taxpayer has reported its true taxable income.

(*3*) The extent to which the taxpayer followed the relevant requirements set forth in regulations under section 482 with respect to the application of the method.

(*4*) The extent to which the taxpayer reasonably relied on a study or other analysis performed by a professional qualified to conduct such a study or analysis, including an attorney, accountant, or economist. Whether the professional is an employee of, or related to, the taxpayer is not determinative in evaluating the reliability of that study or analysis, as long as the study or analysis is objective, thorough, and well reasoned. Such reliance is reasonable only if the taxpayer disclosed to the professional all relevant information regarding the controlled transactions at issue. A study or analysis that was reasonably relied upon in a prior year may reasonably be relied upon in the current year if the relevant facts and circumstances have not changed or if the study or analysis has been appropriately modified to reflect any change in facts and circumstances.

(*5*) If the taxpayer attempted to determine an arm's length result by using more than one uncontrolled comparable, whether the taxpayer arbitrarily selected a result that corresponds to an extreme point in the range of results derived from the uncontrolled comparables. Such a result generally would not likely be closest to an arm's length result. If the uncontrolled comparables that the taxpayer uses to determine an arm's length result are described in §1.482–1(e)(2)(iii)(B), one reasonable method of selecting a point in the range would be that provided in §1.482–1(e)(3).

(*6*) The extent to which the taxpayer relied on a transfer pricing methodology developed and applied pursuant to an Advance Pricing Agreement for a prior taxable year, or specifically approved by the Internal Revenue Service pursuant to a transfer pricing audit of the transactions at issue for a prior taxable year, provided that the taxpayer applied the approved method reasonably and consistently with its prior application, and the facts and circumstances surrounding the use of the method have not materially changed since the time of the IRS's action, or if the facts and circumstances have changed in a way that materially affects the reliability of the results, the taxpayer makes appropriate adjustments to reflect such changes.

(*7*) The size of a net transfer pricing adjustment in relation to the size of the controlled transaction out of which the adjustment arose.

(B) *Services cost method.* A taxpayer's selection of the services cost method for certain services, described in § 1.482–9(b), and its application of that method to a controlled services transaction will be considered reasonable for purposes of the specified method requirement only if the taxpayer reasonably allocated and apportioned costs in accordance with § 1.482–9(k), and reasonably concluded that the controlled services transaction satisfies the requirements described in § 1.482–9(b)(2). Whether the taxpayer's conclusion was reasonable must be determined from all the facts and circumstances. The factors relevant to this determination include those described in paragraph (d)(2)(ii)(A) of this section, to the extent applicable.

(iii) *Documentation requirement*—(A) *In general.* The documentation requirement of this paragraph (d)(2)(iii) is met if the taxpayer maintains sufficient documentation to establish that the taxpayer reasonably concluded that, given the available data and the applicable pricing methods, the method (and its application of that method) provided the most reliable measure of an arm's length result under the principles of the best method rule in § 1.482–1(c), and provides that documentation to the Internal Revenue Service within 30 days of a request for it in connection with an examination of the taxable year to which the documentation relates. With the exception of the documentation described in paragraphs (d)(2)(iii)(B) (*9*) and (*10*) of this section, that documentation must be in existence when the return is filed. The district director may, in his discretion, excuse a minor or inadvertent failure to provide required documents, but only if the taxpayer has made a good faith effort to comply, and the taxpayer promptly remedies the failure when it becomes known. The required documentation is divided into two categories, principal documents and background documents as described in paragraphs (d)(2)(iii) (B) and (C) of this section.

(B) *Principal documents.* The principal documents should accurately and completely describe the basic transfer pricing analysis conducted by the taxpayer. The documentation must include the following—

(*1*) An overview of the taxpayer's business, including an analysis of the economic and legal factors that affect the pricing of its property or services;

(*2*) A description of the taxpayer's organizational structure (including an organization chart) covering all related parties engaged in transactions potentially relevant under section 482, including foreign affiliates whose transactions directly or indirectly affect the pricing of property or services in the United States;

(*3*) Any documentation explicitly required by the regulations under section 482;

(*4*) A description of the method selected and an explanation of why that method was selected, including an evaluation of whether the regulatory conditions and requirements for application of that method, if any, were met;

(*5*) A description of the alternative methods that were considered and an explanation of why they were not selected;

(*6*) A description of the controlled transactions (including the terms of sale) and any internal data used to analyze those transactions. For example, if a profit split method is applied, the documentation must include a schedule providing the total income, costs, and assets (with adjustments for different accounting practices and currencies) for each controlled taxpayer participating in the relevant business activity and detailing the allocations of such items to that activity. Similarly, if a cost-based method (such as the cost plus method, the services cost method for certain services, or a comparable profits method with a cost-based profit level indicator) is applied, the documentation must include a description of the manner in which relevant costs are determined and are allocated and apportioned to the relevant controlled transaction.

(*7*) A description of the comparables that were used, how comparability was evaluated, and what (if any) adjustments were made;

(*8*) An explanation of the economic analysis and projections relied upon in developing the method. For example, if a profit split method is applied, the taxpayer must provide an explanation of the analysis undertaken to determine how the profits would be split;

(*9*) A description or summary of any relevant data that the taxpayer obtains after the end of the tax year and before filing a tax return, which would help determine if a taxpayer selected and applied a specified method in a reasonable manner; and

(*10*) A general index of the principal and background documents and a description of the recordkeeping system used for cataloging and accessing those documents.

(C) *Background documents.* The assumptions, conclusions, and positions contained in principal documents ordinarily will be based on, and supported by, additional background documents. Documents that support the principal documentation may include the documents listed in §1.6038A–3(c) that are not otherwise described in paragraph (d)(2)(iii)(B) of this section. Every document listed in those regulations may not be relevant to pricing determinations under the taxpayer's specific facts and circumstances and, therefore, each of those documents need not be maintained in all circumstances. Moreover, other documents not listed in those regulations may be necessary to establish that the taxpayer's method was selected and applied in the way that provided the most reliable measure of an arm's length result under the principles of the best method rule in §1.482–1(c). Background documents need not be provided to the Internal Revenue Service in response to a request for principal documents. If the Internal Revenue Service subsequently requests background documents, a taxpayer must provide that documentation to the Internal Revenue Service within 30 days of the request. However, the district director may, in his discretion, extend the period for producing the background documentation.

(D) Satisfaction of the documentation requirements described in §1.482–7(k)(2) for the purpose of complying with the rules for CSAs under §1.482–7 also satisfies all of the documentation requirements listed in paragraph (d)(2)(iii)(B) of this section, except the requirements listed in paragraphs (d)(2)(iii)(B)(*2*) and (*10*) of this section, with respect to CSTs and PCTs described in §1.482–7(b)(1)(i) and (ii), provided that the documentation also satisfies the requirements of paragraph (d)(2)(iii)(A) of this section.

(3) *Application of an unspecified method*—(i) *In general.* An adjustment is excluded from the calculation of a net section 482 adjustment if the taxpayer establishes that both the unspecified method and documentation requirements of this paragraph (d)(3) are met with respect to that amount.

(ii) *Unspecified method requirement*—(A) *In general.* If a method other than a specified method was applied, the unspecified method requirement is met if the requirements of paragraph (d)(3)(ii)(B) or (C) of this section, as appropriate, are met.

(B) *Specified method potentially applicable.* If the transaction is of a type for which methods are specified in the regulations under section 482, then a taxpayer will be considered to have met the unspecified method requirement if the taxpayer reasonably concludes, given the available data, that none of the specified methods was likely to provide a reliable measure of an arm's length result, and that it selected and applied an unspecified method in a way that would likely provide a reliable measure of an arm's length result. A taxpayer can reasonably conclude that no specified method was likely to provide a reliable measure of an arm's length result only if it has made a reasonable effort to evaluate the potential applicability of the specified methods in a manner consistent with the principles of the best method rule. However, it is not necessary for a taxpayer to conclude that the selected method provides a more reliable measure of an arm's length result than any other unspecified method. Whether the taxpayer's conclusion was reasonable must be determined from all the facts and circumstances. The factors relevant to this conclusion include those set forth in paragraph (d)(2)(ii) of this section.

(C) *No specified method applicable.* If the transaction is of a type for which no methods are specified in the regulations under section 482, then a taxpayer will be considered to have met the unspecified method requirement if it selected and applied an unspecified method in a reasonable manner. For purposes of this paragraph (d)(3)(ii)(C), a taxpayer's selection and application is reasonable if the taxpayer reasonably concludes that the method (and its application of that method) provided the most reliable measure of an arm's length result under the principles of the best method rule in §1.482–1(c). However, it is not necessary for a taxpayer to conclude that the selected method provides a more reliable measure of an arm's length result than any other unspecified method. Whether the taxpayer's conclusion was reasonable must be determined from all the facts and circumstances. The factors relevant to this conclusion include those set forth in paragraph (d)(2)(ii) of this section.

(iii) *Documentation requirement*—(A) *In general.* The documentation requirement of this paragraph (d)(3) is met if the taxpayer maintains sufficient documentation to establish that the unspecified method requirement of paragraph (d)(3)(ii) of this section is met and provides that documentation to the Internal Revenue Service within 30 days of a request for it. That documentation must be in existence when the return is filed. The district director may, in his discretion, excuse a minor or inadvertent failure to provide required documents, but only if the taxpayer has made a good faith effort to comply, and the taxpayer promptly remedies the failure when it becomes known.

(B) *Principal and background documents.* See paragraphs (d)(2)(iii) (B) and (C) of this section for rules regarding these two categories of required documentation.

(4) *Certain foreign to foreign transactions.* For purposes of calculating a net section 482 adjustment, any increase in taxable income resulting from an allocation under section 482 that is attributable to any controlled transaction solely between foreign corporations will be excluded unless the treatment of that transaction affects the determination of either corporation's income from sources within the United States or taxable income effectively connected with the conduct of a trade or business within the United States.

(5) *Special rule.* If the regular tax (as defined in section 55(c)) imposed on the taxpayer is determined by reference to an amount other than taxable income, that amount shall be treated as the taxable income of the taxpayer for purposes of section 6662(e)(3). Accordingly, for taxpayers whose regular tax is determined by reference to an amount other than taxable income, the increase in that amount resulting from section 482 allocations is the taxpayer's net section 482 adjustment.

(6) *Examples.* The principles of this paragraph (d) are illustrated by the following examples:

Example 1. (i) The Internal Revenue Service makes the following section 482 adjustments for the taxable year:

(1) Attributable to an increase in gross income because of an increase in royalty payments	$9,000,000
(2) Not a 200 percent or 400 percent adjustment	2,000,000
(3) Attributable to a decrease in the cost of goods sold because of a decrease in the cost plus mark-up of a related seller	9,000,000
Total section 482 adjustments	20,000,000

(ii) The taxpayer has gross receipts of 75 million dollars after all section 482 adjustments. The taxpayer establishes that for adjustments number one and three, it applied a transfer pricing method specified in section 482, the selection and application of the method was reasonable, it documented the pricing analysis, and turned that documentation over to the IRS within 30 days of a request. Accordingly, eighteen million dollars is excluded from the calculation of the net section 482 adjustment. Because the net section 482 adjustment is two million dollars, there is no substantial valuation misstatement.

Example 2. (i) The Internal Revenue Service makes the following section 482 adjustments for the taxable year:

(1) Attributable to an increase in gross income because of an increase in royalty payments	$9,000,000
(2) Attributable to an adjustment that is 200 percent or more of the correct section 482 price	2,000,000

(3) Attributable to a decrease in the cost of goods sold because of a decrease in the cost plus mark-up of a related seller	9,000,000
Total section 482 adjustments	20,000,000

(ii) The taxpayer has gross receipts of 75 million dollars after all section 482 adjustments. The taxpayer establishes that for adjustments number one and three, it applied a transfer pricing method specified in section 482, the selection and application of the method was reasonable, it documented that analysis, and turned the documentation over to the IRS within 30 days. Accordingly, eighteen million dollars is excluded from the calculation of the section 482 transfer pricing adjustments for purposes of applying the five million dollar or 10% of gross receipts test. Because the net section 482 adjustment is only two million dollars, the taxpayer is not subject to the net adjustment penalty. However, the taxpayer may be subject to the transactional penalty on the underpayment of tax attributable to the two million dollar adjustment.

Example 3. CFC1 and CFC2 are controlled foreign corporations within the meaning of section 957. Applying section 482, the IRS disallows a deduction for 25 million dollars of the interest that CFC1 paid to CFC2, which results in CFC1's U.S. shareholder having a subpart F inclusion in excess of five million dollars. No other adjustments under section 482 are made with respect to the controlled taxpayers. However, the increase has no effect upon the determination of CFC1's or CFC2's income from sources within the United States or taxable income effectively connected with the conduct of a trade or business within the United States. Accordingly, there is no substantial valuation misstatement.

(e) *Special rules in the case of carrybacks and carryovers.* If there is a substantial or gross valuation misstatement for a taxable year that gives rise to a loss, deduction or credit that is carried to another taxable year, the transactional penalty and the net adjustment penalty will be imposed on any resulting underpayment of tax in that other taxable year. In determining whether there is a substantial or gross valuation misstatement for a taxable year, no amount carried from another taxable year shall be included. The following example illustrates the principle of this paragraph (e):

Example. The Internal Revenue Service makes a section 482 adjustment of six million dollars in taxable year 1, no portion of which is excluded under paragraph (d) of this section. The taxpayer's income tax return for year 1 reported a loss of three million dollars, which was carried to taxpayer's year 2 income tax return and used to reduce income taxes otherwise due with respect to year 2. A determination is made that the six million dollar allocation constitutes a substantial valuation misstatement, and a penalty is imposed on the underpayment of tax in year 1 attributable to the substantial valuation misstatement and on the underpayment of tax in year 2 attributable to the disallowance of the net operating loss in year 2. For purposes of determining whether there is a substantial or gross valuation misstatement for year 2, the three million dollar reduction of the net operating loss will not be added to any section 482 adjustments made with respect to year 2.

(f) *Rules for coordinating between the transactional penalty and the net adjustment penalty*—(1) *Coordination of a net section 482 adjustment subject to the net adjustment penalty and a gross valuation misstatement subject to the transactional penalty.* In determining whether a net section 482 adjustment exceeds five million dollars or 10 percent of gross receipts, an adjustment attributable to a substantial or gross valuation misstatement that is subject to the transactional penalty will be taken into account. If the net section 482 adjustment exceeds five million dollars or ten percent of gross receipts, any portion of such amount that is attributable to a gross valuation misstatement will be subject to the transactional penalty at the forty percent rate, but will not also be subject to net adjustment penalty at a twenty percent rate. The remaining amount is subject to the net adjustment penalty at the twenty percent rate, even if such amount is less than the lesser of five million dollars or ten percent of gross receipts.

(2) *Coordination of net section 482 adjustment subject to the net adjustment penalty and substantial valuation misstatements subject to the transactional penalty.* If the net section 482 adjustment exceeds twenty million dollars or 20 percent of gross receipts, the entire amount of the adjustment is subject to the net adjustment penalty at a forty percent rate. No portion of the adjustment is subject to the transactional penalty at a twenty percent rate.

(3) *Examples.* The following examples illustrate the principles of this paragraph (f):

Example 1. (i) Applying section 482, the Internal Revenue Service makes the following adjustments for the taxable year:

(1) Attributable to an adjustment that is 400 percent or more of the correct section 482 arm's length result	$2,000,000
(2) Not a 200 or 400 percent adjustment	2,500,000
Total	4,500,000

(ii) The taxpayer has gross receipts of 75 million dollars after all section 482 adjustments. None of the adjustments is excluded under paragraph (d) (Amounts excluded from net section 482 adjustments) of this section, in determining the five million dollar or 10% of gross receipts test under section 6662(e)(1)(B)(ii). The net section 482 adjustment (4.5 million dollars) is less than the lesser of five million dollars or ten percent of gross receipts ($75 million × 10% = $7.5 million). Thus, there is no substantial valuation misstatement. However, the two million dollar adjustment is attributable to a gross valuation misstatement. Accordingly, the taxpayer may be subject to a penalty, under section 6662(h), equal to 40 percent of the underpayment of tax attributable to the gross valuation misstatement of two million dollars. The 2.5 million dollar adjustment is not subject to a penalty under section 6662(b)(3).

Example 2. The facts are the same as in *Example 1,* except the taxpayer has gross receipts of 40 million dollars. The net section 482 adjustment ($4.5 million) is greater than the lesser of five million dollars or ten percent of gross receipts ($40 million × 10% = $4 million). Thus, the five million dollar or 10% of gross receipts test has been met. The two million dollar adjustment is attributable to a gross valuation misstatement. Accordingly, the taxpayer is subject to a penalty, under section 6662(h), equal to 40 percent of the underpayment of tax attributable to the gross valuation misstatement of two million dollars. The 2.5 million dollar adjustment is subject to a penalty under sections 6662(a) and 6662(b)(3), equal to 20 percent of the underpayment of tax attributable to the substantial valuation misstatement.

Example 3. (i) Applying section 482, the Internal Revenue Service makes the following transfer pricing adjustments for the taxable year:

(1) Attributable to an adjustment that is 400 percent or more of the correct section 482 arm's length result	$6,000,000
(2) Not a 200 or 400 percent adjustment	15,000,000
Total	21,000,000

(ii) None of the adjustments are excluded under paragraph (d) (Amounts excluded from net section 482 adjustments) in determining the twenty million dollar or 20% of gross receipts test under section 6662(h). The net section 482 adjustment (21 million dollars) is greater than twenty million dollars and thus constitutes a gross valuation misstatement. Accordingly, the total adjustment is subject to the net adjustment penalty equal to 40 percent of the underpayment of tax attributable to the 21 million dollar gross valuation misstatement. The six million dollar adjustment will not be separately included for purposes of any additional penalty under section 6662.

(g) *Effective/applicability date*—(1) *In general.* This section is generally applicable on February 9, 1996. However, taxpayers may elect to apply this section to all open taxable years beginning after December 31, 1993.

(2) *Special rules.* The provisions of paragraphs (d)(2)(ii)(B), (d)(2)(iii)(B)(*4*) and (d)(2)(iii)(B)(*6*) of this section are applicable for taxable years beginning after July 31, 2009. However, taxpayers may elect to apply the provisions of paragraphs (d)(2)(ii)(B), (d)(2)(iii)(B)(*4*) and (d)(2)(iii)(B)(*6*) of this section to earlier taxable years in accordance with the rules set forth in §1.482–9(n)(2).

[T.D. 8656, 61 FR 4880, Feb. 9, 1996; T.D. 8656, 61 FR 14248, Apr. 1, 1996; 62 FR 46877, Sept. 5, 1997, as amended by T.D. 9278, 71 FR 44518, Aug. 4, 2006; T.D. 9441, 74 FR 390, Jan. 5, 2009; T.D. 9456, 74 FR 38875, Aug. 4, 2009; T.D. 9568, 76 FR 80136, Dec. 22, 2011]

§ 1.6662–7 Omnibus Budget Reconciliation Act of 1993 changes to the accuracy-related penalty.

(a) *Scope.* The Omnibus Budget Reconciliation Act of 1993 made certain changes to the accuracy-related penalty in section 6662. This section provides rules reflecting those changes.

(b) *No disclosure exception for negligence penalty.* The penalty for negligence in section 6662(b)(1) may not be avoided by disclosure of a return position.

(c) *Disclosure standard for other penalties is reasonable basis.* The penalties for disregarding rules or regulations in section 6662(b)(1) and for a substantial understatement of income tax in section 6662(b)(2) may be avoided by adequate disclosure of a return position only if the position has at least a reasonable basis. See §1.6662–3(c) and §§1.6662–4(e) and (f) for other applicable disclosure rules.

(d) *Reasonable basis.* For purposes of §§1.6662–3(c) and 1.6662–4(e) and (f) (relating to methods of making adequate disclosure), the provisions of §1.6662–

3(b)(3) apply in determining whether a return position has a reasonable basis.

[T.D. 8617, 60 FR 45665, Sept. 1, 1995, as amended by T.D. 8790, 63 FR 66435, Dec. 2, 1998]

§ 1.6664–0 Table of contents.

This section lists the captions in §§ 1.6664–1 through 1.6664–4T.

[T.D. 8381, 56 FR 67505, Dec. 31, 1991, as amended by T.D. 8519, 59 FR 4799, Feb. 2, 1994; T.D. 8617, 60 FR 45666, Sept. 1, 1995; T.D. 8656, 61 FR 4885, Feb. 9, 1996; T.D. 8790, 63 FR 66435, Dec. 2, 1998; T.D. 9109, 68 FR 75128, Dec. 30, 2003; T.D. 9309, 72 FR 903, Jan. 9, 2007]

§ 1.6664–1 Accuracy-related and fraud penalties; definitions, effective date and special rules.

(a) *In general.* Section 6664(a) defines the term ''underpayment'' for purposes of the accuracy-related penalty under section 6662 and the fraud penalty under section 6663. The definition of ''underpayment'' of income taxes imposed under subtitle A is set forth in § 1.6664–2. Ordering rules for computing the total amount of accuracy-related and fraud penalties imposed with respect to a return are set forth in § 1.6664–3. Section 6664(c) provides a reasonable cause and good faith exception to the accuracy-related penalty. Rules relating to the reasonable cause and good faith exception are set forth in § 1.6664–4.

(b) *Effective date*—(1) *In general.* Sections 1.6664–1 through 1.6664–3 apply to returns the due date of which (determined without regard to extensions of time for filing) is after December 31, 1989.

(2) *Reasonable cause and good faith exception to section 6662 penalties.* (i) *For returns due after September 1, 1995.* Section 1.6664–4 applies to returns the due date of which (determined without regard to extensions of time for filing) is after September 1, 1995. Except as provided in the last sentence of this paragraph (b)(2), §1.6664–4 (as contained in 26 CFR part 1 revised April 1, 1995) applies to returns the due date of which (determined without regard to extensions of time for filing) is on or before September 1, 1995 and after December 31, 1989. For transactions occurring after December 8, 1994, §1.6664–4 (as contained in 26 CFR part 1 revised April 1, 1995) is applied taking into account the changes made to section 6662(d)(2)(C) (relating to the substantial understatement penalty for tax shelter items of corporations) by section 744 of title VII of the Uruguay Round Agreements Act, Pub. L. 103–465 (108 Stat. 4809).

(ii) *For returns filed after December 31, 2002.* Sections 1.6664–4(c) (relating to relying on opinion or advice) and (d) (relating to underpayments attributable to reportable transactions) apply to returns filed after December 31, 2002, with respect to transactions entered into on or after January 1, 2003. Except as provided in paragraph (b)(2)(i) of this section, §1.6664–4 (as contained in 26 CFR part 1 revised April 1, 2003) applies to returns filed with respect to transactions entered into before January 1, 2003.

(3) *Qualified amended returns.* Sections 1.6664–2(c)(1), (c)(2), (c)(3)(i)(A), (c)(3)(i)(B), (c)(3)(i)(C), (c)(3)(i)(D)(*2*), (c)(3)(i)(E), and (c)(4) are applicable for amended returns and requests for administrative adjustment filed on or after March 2, 2005. Sections 1.6664–2(c)(3)(i)(D)(*1*) and (c)(3)(ii)(B) and (C) are applicable for amended returns and requests for administrative adjustment filed on or after April 30, 2004. The applicability date for §1.6664–2(c)(3)(ii)(A) varies depending upon which event occurs under §1.6664–2(c)(3)(i). For purposes of §1.6664–2(c)(3)(ii)(A), the date described in §1.6664–2(c)(3)(i)(D)(*1*) is applicable for amended returns and requests for administrative adjustment filed on or after April 30, 2004. For purposes of §1.6664–2(c)(3)(ii)(A), the dates described in §1.6664–2(c)(3)(i)(A), (B), (C), (D)(*2*), and (E) are applicable for amended returns and requests for administrative adjustment filed on or after March 2, 2005. Section 1.6664–2(c)(1) through (c)(3), as contained in 26 CFR part 1 revised as of April 1, 2004 and as modified by Notice 2004–38, 2004–1 C.B. 949, applies with respect to returns and requests for administrative adjustment filed on or after April 30, 2004 and before March 2, 2005. Section 1.6664–2(c)(1) through (3), as contained in 26 CFR part 1 revised as of April 30, 2004, applies with respect to returns and requests for administrative adjustment filed before April 30, 2004.

[T.D. 8381, 56 FR 67506, Dec. 31, 1991, as amended by T.D. 8617, 60 FR 45666, Sept. 1, 1995; T.D. 9109, 68 FR 75128, Dec. 30, 2003; T.D. 9309, 72 FR 903, Jan. 9, 2007]

§ 1.6664–2 Underpayment.

(a) *Underpayment defined.* In the case of income taxes imposed under subtitle A, an underpayment for purposes of section 6662, relating to the accuracy-related penalty, and section 6663, relating to the fraud penalty, means the amount by which any income tax imposed under this subtitle (as defined in paragraph (b) of the section) exceeds the excess of—

(1) The sum of—

(i) The amount shown as the tax by the taxpayer on his return (as defined in paragraph (c) of this section), plus

(ii) Amounts not so shown previously assessed (or collected without assessment) (as defined in paragraph (d) of this section), over

(2) The amount of rebates made (as defined in paragraph (e) of this section).

The definition of underpayment also may be expressed as—

$$\text{Underpayment} = W - (X + Y - Z),$$

where *W*=the amount of income tax imposed; *X*=the amount shown as the tax by the taxpayer on his return; *Y*=amounts not so shown previously assessed (or collected without assessment); and *Z*=the amount of rebates made.

(b) *Amount of income tax imposed.* For purposes of paragraph (a) of this section, the ''amount of income tax imposed'' is the amount of tax imposed on the taxpayer under subtitle A for the taxable year, determined without regard to—

(1) The credits for tax withheld under sections 31 (relating to tax withheld on wages) and 33 (relating to tax withheld at source on nonresident aliens and foreign corporations);

(2) Payments of tax or estimated tax by the taxpayer;

(3) Any credit resulting from the collection of amounts assessed under section 6851 as the result of a termination assessment, or section 6861 as the result of a jeopardy assessment; and

(4) Any tax that the taxpayer is not required to assess on the return (such as the tax imposed by section 531 on the accumulated taxable income of a corporation).

(c) *Amount shown as the tax by the taxpayer on his return*—(1) *Defined.* For purposes of paragraph (a) of this section, the *amount shown as the tax by the taxpayer on his return* is the tax liability shown by the taxpayer on his return, determined without regard to the items listed in paragraphs (b)(1), (2), and (3) of this section, except that it is reduced by the excess of—

(i) The amounts shown by the taxpayer on his return as credits for tax withheld under section 31 (relating to tax withheld on wages) and section 33 (relating to tax withheld at source on nonresident aliens and foreign corporations), as payments of estimated tax, or as any other payments made by the taxpayer with respect to a taxable year before filing the return for such taxable year, over

(ii) The amounts actually withheld, actually paid as estimated tax, or actually paid with respect to a taxable year before the return is filed for such taxable year.

(2) *Effect of qualified amended return.* The *amount shown as the tax by the taxpayer on his return* includes an amount shown as additional tax on a qualified amended return (as defined in paragraph (c)(3) of this section), except that such amount is not included if it relates to a fraudulent position on the original return.

(3) *Qualified amended return defined*—(i) *General rule.* A *qualified amended return* is an amended return, or a timely request for an administrative adjustment under section 6227, filed after the due date of the return for the taxable year (determined with regard to extensions of time to file) and before the earliest of—

(A) The date the taxpayer is first contacted by the Internal Revenue Service (IRS) concerning any examination (including a criminal investigation) with respect to the return;

(B) The date any person is first contacted by the IRS concerning an examination of that person under section 6700 (relating to the penalty for promoting abusive tax shelters) for an activity with respect to which the taxpayer claimed any tax benefit on the return directly or indirectly through the entity, plan or arrangement described in section 6700(a)(1)(A);

(C) In the case of a pass-through item (as defined in §1.6662–4(f)(5)), the date the pass-through entity (as defined in §1.6662–4(f)(5)) is first contacted by the IRS in connection with an examination of the return to which the pass-through item relates;

(D)(*1*) The date on which the IRS serves a summons described in section 7609(f) relating to the tax liability of a person, group, or class that includes the taxpayer (or pass-through entity of which the taxpayer is a partner, shareholder, beneficiary, or holder of a residual interest in a REMIC) with respect to an activity for which the taxpayer claimed any tax benefit on the return directly or indirectly.

(*2*) The rule in paragraph (c)(3)(i)(D)(*1*) of this section applies to any return on which the taxpayer claimed a direct or indirect tax benefit from the type of activity that is the subject of the summons, regardless of whether the summons seeks the production of information for the taxable period covered by such return; and

(E) The date on which the Commissioner announces by revenue ruling, revenue procedure, notice, or announcement, to be published in the Internal Revenue Bulletin (see

§ 601.601(d)(2) of this chapter), a settlement initiative to compromise or waive penalties, in whole or in part, with respect to a listed transaction. This rule applies only to a taxpayer who participated in the listed transaction and for the taxable year(s) in which the taxpayer claimed any direct or indirect tax benefits from the listed transaction. The Commissioner may waive the requirements of this paragraph or identify a later date by which a taxpayer who participated in the listed transaction must file a qualified amended return in the published guidance announcing the listed transaction settlement initiative.

(ii) *Undisclosed listed transactions.* An *undisclosed listed transaction* is a transaction that is the same as, or substantially similar to, a listed transaction within the meaning of § 1.6011–4(b)(2) (regardless of whether § 1.6011–4 requires the taxpayer to disclose the transaction) and was neither previously disclosed by the taxpayer within the meaning of § 1.6011–4 or § 1.6011–4T, nor disclosed under Announcement 2002–2 (2002–1 C.B. 304), (see § 601.601(d)(2)(ii) of this chapter) by the deadline therein. In the case of an *undisclosed listed transaction* for which a taxpayer claims any direct or indirect tax benefits on its return (regardless of whether the transaction was a listed transaction at the time the return was filed), an amended return or request for administrative adjustment under section 6227 will not be a *qualified amended return* if filed on or after the earliest of—

(A) The dates described in paragraph (c)(3)(i) of this section;

(B) The date on which the IRS first contacts any person regarding an examination of that person's liability under section 6707(a) with respect to the undisclosed listed transaction of the taxpayer; or

(C) The date on which the IRS requests, from any person who made a tax statement to or for the benefit of the taxpayer or from any person who gave the taxpayer material aid, assistance, or advice as described in section 6111(b)(1)(A)(i) with respect to the taxpayer, the information required to be included on a list under section 6112 relating to a transaction that was the same as, or substantially similar to, the undisclosed listed transaction, regardless of whether the taxpayer's information is required to be included on that list.

(4) *Special rules.* (i) A qualified amended return includes an amended return that is filed to disclose information pursuant to § 1.6662–3(c) or § 1.6662–4(e) and (f) even though it does not report any additional tax liability. See § 1.6662–3(c), § 1.6662–4(f), and § 1.6664–4(c) for rules relating to adequate disclosure.

(ii) The Commissioner may by revenue procedure prescribe the manner in which the rules of paragraph (c) of this section regarding qualified amended returns apply to particular classes of taxpayers.

(5) *Examples.* The following examples illustrate the provisions of paragraphs (c)(3) and (c)(4) of this section:

Example 1. T, an individual taxpayer, claimed tax benefits on its 2002 Federal income tax return from a transaction that is substantially similar to the transaction identified as a listed transaction in Notice 2002–65, 2002–2 C.B. 690 (Partnership Entity Straddle Tax Shelter). T did not disclose his participation in this transaction on a Form 8886, ''Reportable Transaction Disclosure Statement,'' as required by § 1.6011–4. On June 30, 2004, the IRS requested from P, T's material advisor, an investor list required to be maintained under section 6112. The section 6112 request, however, related to the type of transaction described in Notice 2003–81, 2003–2 C.B. 1223 (Tax Avoidance Using Offsetting Foreign Currency Option Contracts). T did not participate in (within the meaning of § 1.6011–4(c)) a transaction described in Notice 2003–81. T may file a qualified amended return relating to the transaction described in Notice 2002–65 because T did not claim a tax benefit with respect to the listed transaction described in Notice 2003–81, which is the subject of the section 6112 request.

Example 2. The facts are the same as in *Example 1,* except that T's 2002 Federal income tax return reflected T's participation in the transaction described in Notice 2003–81. As of June 30, 2004, T may not file a qualified amended return for the 2002 tax year.

Example 3. (i) Corporation X claimed tax benefits from a transaction on its 2002 Federal income tax return. In October 2004, the IRS and Treasury Department identified the transaction as a listed transaction. In December 2004, the IRS contacted P concerning an examination of P's liability under section 6707(a) (as in effect prior to the amendment to section 6707 by section 816 of the American Jobs Creation Act of 2004 (the Jobs Act), Public Law 108–357 (118 Stat. 1418)). P is the organizer of a section 6111 tax shelter (as in effect prior to the amendment to section 6111 by section 815 of the Jobs Act) who provided representations to X regarding tax benefits from the transaction, and the IRS has contacted P about the failure to register that transaction. Three days later, X filed an amended return.

(ii) X's amended return is not a qualified amended return, because X did not disclose the transaction before the IRS contacted P. X's amended return would have been a qualified amended return if it was submitted prior to the date on which the IRS contacted P.

Example 4. The facts are the same as in *Example 3* except that, instead of contacting P concerning an examination under section 6707(a), in December 2004, the IRS served P with a John Doe summons described in section 7609(f) relating to the tax liability of participants in the type of transaction for which X claimed tax benefits on its return. X cannot file a qualified amended return after the John Doe summons has been served regardless of when, or whether, the transaction becomes a listed transaction.

Example 5. On November 30, 2003, the IRS served a John Doe summons described in section 7609(f) on Corporation Y, a credit card company. The summons requested the identity of, and information concerning, United States taxpayers who, during the taxable years 2001 and 2002, had signature authority over Corporation Y's credit cards issued by, through, or on behalf of certain offshore financial institutions. Corporation Y complied with the summons, and identified, among others, Taxpayer B. On May 31, 2004, before the IRS first contacted Taxpayer B concerning an examination of Taxpayer B's Federal income tax return for the taxable year 2002, Taxpayer B filed an amended return for that taxable year, that showed an increase in Taxpayer B's Federal income tax liability. Under paragraph (c)(3)(i)(D) of this section, the amended return is not a qualified amended return because it was not filed before the John Doe summons was served on Corporation Y.

Example 6. The facts are the same as in *Example 5.* Taxpayer B continued to maintain the offshore credit card account through 2003 and filed an original tax return for the 2003 taxable year claiming tax benefits attributable to the existence of the account. On March 21, 2005, Taxpayer B filed an amended return for the taxable year 2003, that showed an increase in Taxpayer B's Federal income tax liability. Under paragraph (c)(3)(i)(D) of this section, the amended return is not a qualified amended return because it was not filed before the John Doe summons for 2001 and 2002 was served on Corporation Y, and the return reflects benefits from the type of activity that is the subject of the John Doe summons.

Example 7. (i) On November 30, 2003, the IRS served a John Doe summons described in section 7609(f) on Corporation Y, a credit card company. The summons requested the identity of, and information concerning, United States taxpayers who, during the taxable years 2001 and 2002, had signature authority over Corporation Y's credit cards issued by, through, or on behalf of certain offshore financial institutions. Taxpayer C did not have signature authority over any of Corporation Y's credit cards during either 2001 or 2002 and, therefore, was not a person described in the John Doe summons.

(ii) In 2003, Taxpayer C first acquired signature authority over a Corporation Y credit card issued by an offshore financial institution. Because Taxpayer C did not have signature authority during 2001 or 2002 over a Corporation Y credit card issued by an offshore financial institution, and was therefore not covered by the John Doe summons served on November 30, 2003, Taxpayer C's ability to file a qualified amended return for the 2003 taxable year is not limited by paragraph (c)(3)(i)(D) of this section.

(d) *Amounts not so shown previously assessed (or collected without assessment).* For purposes of paragraph (a) of this section, ''amounts not so shown previously assessed'' means only amounts assessed before the return is filed that were not shown on the return, such as termination assessments under section 6851 and jeopardy assessments under section 6861 made prior to the filing of the return for the taxable year. For purposes of paragraph (a) of this section, the amount ''collected without assessment'' is the amount by which the total of the credits allowable under section 31 (relating to tax withheld on wages) and section 33 (relating to tax withheld at source on nonresident aliens and foreign corporations), estimated tax payments, and other payments in satisfaction of tax liability made before the return is filed, exceed the tax shown on the return (provided such excess has not been refunded or allowed as a credit to the taxpayer).

(e) *Rebates.* The term ''rebate'' means so much of an abatement credit, refund or other repayment, as was made on the ground that the tax imposed was less than the excess of—

(1) The sum of—

(i) The amount shown as the tax by the taxpayer on his return, plus

(ii) Amounts not so shown previously assessed (or collected without assessment), over

(2) Rebates previously made.

(f) *Underpayments for certain carryback years not reduced by amount of carrybacks.* The amount of an underpayment for a taxable year that is attributable to conduct proscribed by sections 6662 or 6663 is not reduced on account of a carryback of a loss, deduction or credit to that year. Such conduct includes negligence or disregard of rules or regulations; a substantial understatement of income tax; and a substantial (or gross) valuation misstatement under chapter 1, provided that the applicable dollar limitation is satisfied for the carryback year.

(g) *Examples.* The following examples illustrate this section:

Example 1. Taxpayer's 1990 return showed a tax liability of $18,000. Taxpayer had no amounts previously assessed (or collected without assessment) and received no rebates of tax. Taxpayer claimed a credit in the amount of $23,000 for income tax withheld under section 3402, which resulted in a refund received of $5,000. It is later determined that the taxpayer should have reported additional income and that the correct tax for the taxable year is $25,500. There is an underpayment of $7,500, determined as follows:

Tax imposed under subtitle A		$25,500
Tax shown on return	$18,000	
Tax previously assessed (or collected without assessment)	None	
Amount of rebates made	None	
Balance		$18,000
Underpayment		$7,500

Example 2. The facts are the same as in *Example 1* except that the taxpayer failed to claim on the return a credit of $1,500 for income tax withheld. This $1,500 constitutes an amount collected without assessment as defined in paragraph (d) of this section. The underpayment is $6,000, determined as follows:

Tax imposed under subtitle A		$25,500
Tax shown on return	$18,000	
Tax previously assessed (or collected without assessment)	1,500	
Amount of rebates made	None	
Balance		$19,500
Underpayment		$6,000

Example 3. On Form 1040 filed for tax year 1990, taxpayer reported a tax liability of $10,000, estimated tax payments of $15,000, and received a refund of $5,000. Estimated tax payments actually made with respect to tax year 1990 were only $7,000. For purposes of determining the amount of underpayment subject to a penalty under section 6662 or section 6663, the tax shown on the return is $2,000 (reported tax liability of $10,000 reduced by the overstated estimated tax of $8,000 ($15,000–$7,000)). The underpayment is $8,000, determined as follows:

Tax imposed under subtitle A		$10,000
Tax shown on return	$2,000	
Tax previously assessed (or collected without assessment)	None	
Amount of rebates made	None	
Balance		$2,000
Underpayment		$8,000

[T.D. 8381, 56 FR 67506, Dec. 31, 1991; T.D. 8381, 57 FR 6165, Feb. 20, 1992, as amended by T.D. 9186, 70 FR 10039, Mar. 2, 2005; T.D. 9309, 72 FR 903, Jan. 9, 2007]

§ 1.6664–3 Ordering rules for determining the total amount of penalties imposed.

(a) *In general.* This section provides rules for determining the order in which adjustments to a return are taken into account for the purpose of computing the total amount of penalties imposed under sections 6662 and 6663, where—

(1) There is at least one adjustment with respect to which no penalty has been imposed and at least one with respect to which a penalty has been imposed, or

(2) There are at least two adjustments with respect to which penalties have been imposed and they have been imposed at different rates.

This section also provides rules for allocating unclaimed prepayment credits to adjustments to a return.

(b) *Order in which adjustments are taken into account.* In computing the portions of an underpayment subject to penalties imposed under sections 6662 and 6663, adjustments to a return are considered made in the following order:

(1) Those with respect to which no penalties have been imposed.

(2) Those with respect to which a penalty has been imposed at a 20 percent rate (*i.e.*, a penalty for negligence or disregard of rules or regulations, substantial understatement of income tax, or substantial valuation misstatement, under sections 6662(b)(1) through 6662(b)(3), respectively).

(3) Those with respect to which a penalty has been imposed at a 40 percent rate (*i.e.*, a penalty for a gross valuation misstatement under sections 6662 (b)(3) and (h)).

(4) Those with respect to which a penalty has been imposed at a 75 percent rate (*i.e.*, a penalty for fraud under section 6663).

(c) *Manner in which unclaimed prepayment credits are allocated.* Any income tax withholding or other payment made before a return was filed, that was neither claimed on the return nor previously allowed as a credit against the tax liability for the taxable year (an ''unclaimed prepayment credit''), is allocated as follows—

(1) If an unclaimed prepayment credit is allocable to a particular adjustment, such credit is applied in full in determining the amount of the underpayment resulting from such adjustment.

(2) If an unclaimed prepayment credit is not allocable to a particular adjustment, such credit is applied in accordance with the ordering rules set forth in paragraph (b) of this section.

(d) *Examples.* The following examples illustrate the rules of this §1.6664–3. These examples do not take into account the reasonable cause exception to the accuracy-related penalty under §1.6664–4.

Example 1. A and B, husband and wife, filed a joint federal income tax return for calendar year 1989, reporting taxable income of $15,800 and a tax liability of $2,374. A and B had no amounts previously assessed (or collected without assessment) and no rebates had been made. Subsequently, the return was examined and the following adjustments and penalties were agreed to:

Adjustment #1 (No penalty imposed)		$1,000
Adjustment #2 (Substantial understatement penalty imposed)		40,000
Adjustment #3 (Civil fraud penalty imposed)		45,000
Total adjustments		$86,000
Taxable income shown on return		15,800
Taxable income as corrected		$101,800
Computation of underpayment:		
Tax imposed by subtitle A		$25,828
Tax shown on return	$2,374	
Previous assessments	None	
Rebates	None	
Balance		$2,374
Underpayment		$23,454

Computation of the portions of the underpayment on which penalties under section 6662(b)(2) and section 6663 are imposed:

Step 1 Determine the portion, if any, of the underpayment on which no accuracy-related or fraud penalty is imposed:

Taxable income shown on return	$15,800
Adjustment #1	1,000
''Adjusted'' taxable income	$16,800
Tax on ''adjusted'' taxable income	$2,524
Tax shown on return	2,374
Portion of underpayment on which no penalty is imposed	$150

Step 2 Determine the portion, if any, of the underpayment on which a penalty of 20 percent is imposed:

''Adjusted'' taxable income from step 1	$16,800
Adjustment #2	40,000
''Adjusted'' taxable income	56,800
Tax on ''adjusted'' taxable income	$11,880
Tax on ''adjusted'' taxable income from step 1	$2,524
Portion of underpayment on which 20 percent penalty is imposed	$9,356

Step 3 Determine the portion, if any, of the underpayment on which a penalty of 75 percent is imposed:

Total underpayment		$23,454
Less the sum of the portions of such underpayment determined in:		
Step 1	$150	
Step 2	9,356	
Total		$9,506
Portion of underpayment on which 75 percent penalty is imposed		$13,948

Example 2. The facts are the same as in *Example 1* except that the taxpayers failed to claim on their return a credit of $1,500 for income tax withheld on unreported additional income that resulted in Adjustment #2. Because the unclaimed prepayment credit is allocable to Adjustment #2, the portion of the underpayment attributable to that adjustment is $7,856 ($9,356—$1,500). The portions of the underpayment attributable to Adjustments #1 and #3 remain the same.

Example 3. The facts are the same as in *Example 1* except that the taxpayers made a timely estimated tax payment of $1,500 for 1989 which they failed to claim (and which the Service had not previously allowed). This unclaimed prepayment credit is not allocable to any particular adjustment. Therefore, the credit is allocated first to the portion of the underpayment on which no penalty is imposed ($150). The remaining amount ($1,350) is allocated next to the 20 percent penalty portion of the underpayment ($9,356). Thus, the portion of the underpayment that is not penalized is zero ($150—$150), the portion subject to a 20 percent penalty is $8,006 ($9,356—$1,350) and the portion subject to a 75 percent penalty is unchanged at $13,948.

[T.D. 8381, 56 FR 67507, Dec. 31, 1991; T.D. 8381, 57 FR 6165, Feb. 20, 1992]

§ 1.6664–4 Reasonable cause and good faith exception to section 6662 penalties.

(a) *In general.* No penalty may be imposed under section 6662 with respect to any portion of an underpayment upon a showing by the taxpayer that there was reasonable cause for, and the taxpayer acted in good faith with respect to, such portion. Rules for determining whether the reasonable cause and good faith exception applies are set forth in paragraphs (b) through (h) of this section.

(b) *Facts and circumstances taken into account*—(1) *In general.* The 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. (See paragraph (e) of this section for certain rules relating to a substantial understatement penalty attributable to tax shelter items of corporations.) 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. An isolated computational or transcriptional error generally is not inconsistent with reasonable cause and good faith. Reliance on an information return or on the advice of a professional tax advisor or an appraiser does not necessarily demonstrate reasonable cause and good faith. Similarly, reasonable cause and good faith is not necessarily indicated by reliance on facts that, unknown to the taxpayer, are incorrect. Reliance on an information return, professional advice, or other facts, however, constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. (See paragraph (c) of this section for certain rules relating to reliance on the advice of others.) For example, reliance on erroneous information (such as an error relating to the cost or adjusted basis of property, the date property was placed in service, or the amount of opening or closing inventory) inadvertently included in data compiled by the various divisions of a multidivisional corporation or in financial books and records prepared by those divisions generally indicates reasonable cause and good faith, provided the corporation employed internal controls and procedures, reasonable under the circumstances, that were designed to identify such factual errors. Reasonable cause and good faith ordinarily is not indicated by the mere fact that there is an appraisal of the value of property. Other factors to consider include the methodology and assumptions underlying the appraisal, the appraised value, the relationship between appraised value and purchase price, the circumstances under which the appraisal was obtained, and the appraiser's relationship to the taxpayer or to the activity in which the property is used. (See paragraph (g) of this section for certain rules relating to appraisals for charitable deduction property.) A taxpayer's reliance on erroneous information reported on a Form W-2, Form 1099, or other information return indicates reasonable cause and good faith, provided the taxpayer did not know or have reason to know that the information was incorrect. Generally, a taxpayer knows, or has reason to know, that the information on an information return is incorrect if such information is inconsistent with other information reported or otherwise furnished to the taxpayer, or with the taxpayer's knowledge of the transaction. This knowledge includes, for example, the taxpayer's knowledge of the terms of his employment relationship or of the rate of return on a payor's obligation.

(2) *Examples.* The following examples illustrate this paragraph (b). They do not involve tax shelter items. (See paragraph (e) of this section for certain rules relating to the substantial understatement penalty attributable to the tax shelter items of corporations.)

Example 1. A, an individual calendar year taxpayer, engages B, a professional tax advisor, to give A advice concerning the deductibility of certain state and local taxes. A provides B with full details concerning the taxes at issue. B advises A that the taxes are fully deductible. A, in preparing his own tax return, claims a deduction for the taxes. Absent other facts, and assuming the facts and circumstances surrounding B's advice and A's reliance on such advice satisfy the requirements of paragraph (c) of this section, A is considered to have demonstrated good faith by seeking the advice of a professional tax advisor, and to have shown reasonable cause for any underpayment attributable to the deduction claimed for the taxes. However, if A had sought advice from someone that A knew, or should have known, lacked knowledge in the relevant aspects of Federal tax law, or if other facts demonstrate that A failed to act reasonably or in good faith, A would not be considered to have shown reasonable cause or to have acted in good faith.

Example 2. C, an individual, sought advice from D, a friend who was not a tax professional, as to how C might reduce his Federal tax obligations. D advised C that, for a nominal investment in Corporation X, D had received certain tax benefits which virtually eliminated D's Federal tax liability. D also named other investors who had received similar benefits. Without further inquiry, C invested in X and claimed the benefits that he had been assured by D were due him. In this case, C did not make any good faith attempt to ascertain the correctness of what D had advised him concerning his tax matters, and is not considered to have reasonable cause for the underpayment attributable to the benefits claimed.

Example 3. E, an individual, worked for Company X doing odd jobs and filling in for other employees when necessary. E worked irregular hours and was paid by the hour. The amount of E's pay check differed from week to week. The Form W-2 furnished to E reflected wages for 1990 in the amount of $29,729. It did not, however, include compensation of $1,467 paid for some hours E worked. Relying on the Form W-2, E filed a return reporting wages of $29,729. E had no reason to know that the amount reported on the Form W-2 was incorrect. Under the circumstances, E is considered to have acted in good faith in relying on the Form W-2 and to have reasonable cause for the underpayment attributable to the unreported wages.

Example 4. H, an individual, did not enjoy preparing his tax returns and procrastinated in doing so until April 15th. On April 15th, H hurriedly gathered together his tax records and materials, prepared a return, and mailed it before midnight. The return contained numerous errors, some of which were in H's favor and some of which were not. The net result of all the adjustments, however, was an underpayment of tax by H. Under these circumstances, H is not considered to have reasonable cause for the underpayment or to have acted in good faith in attempting to file an accurate return.

(c) *Reliance on opinion or advice*—(1) *Facts and circumstances; minimum requirements.* All facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice (including the opinion of a professional tax advisor) as to the treatment of the taxpayer (or any entity, plan, or arrangement) under Federal tax law. For example, the taxpayer's education, sophistication and business experience will be relevant in determining whether the taxpayer's reliance on tax advice was reasonable and made in good faith. In no event will a taxpayer be considered to have reasonably relied in good faith on advice (including an opinion) unless the requirements of this paragraph (c)(1) are satisfied. The fact that these requirements are satisfied, however, will not necessarily establish that the taxpayer reasonably relied on the advice (including the opinion of a tax advisor) in good faith. For example, reliance may not be reasonable or in good faith if the taxpayer knew, or reasonably should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.

(i) *All facts and circumstances considered.* The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. For example, the advice must take into account the taxpayer's purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner. In addition, the requirements of this paragraph (c)(1) are not satisfied if the taxpayer fails to disclose a fact that it knows, or reasonably should know, to be relevant to the proper tax treatment of an item.

(ii) *No unreasonable assumptions.* The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. For example, the advice must not be based upon a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner.

(iii) *Reliance on the invalidity of a regulation.* A taxpayer may not rely on an opinion or advice that a regulation is invalid to establish that the taxpayer acted with reasonable cause and good faith unless the taxpayer adequately disclosed, in accordance with §1.6662–3(c)(2), the position that the regulation in question is invalid.

(2) *Advice defined.* Advice is any communication, including the opinion of a professional tax advisor, setting forth the analysis or conclusion of a person, other than the taxpayer, provided to (or for the benefit of) the taxpayer and on which the taxpayer relies, directly or indirectly, with respect to the imposition of the section 6662 accuracy-related penalty. Advice does not have to be in any particular form.

(3) *Cross-reference.* For rules applicable to advisors, see e.g., §§1.6694–1 through 1.6694–3 (regarding preparer penalties), 31 CFR 10.22 (regarding diligence as to accuracy), 31 CFR 10.33 (regarding tax shelter opinions), and 31 CFR 10.34 (regarding standards for advising with respect to tax return positions and for preparing or signing returns).

(d) *Underpayments attributable to reportable transactions.* If any portion of an underpayment is attributable to a reportable transaction, as defined in §1.6011–4(b) (or §1.6011–4T(b), as applicable), then failure by the taxpayer to disclose the transaction in accordance with §1.6011–4 (or §1.6011–4T, as applicable) is a strong indication that the taxpayer did not act in good faith with respect to the portion of the underpayment attributable to the reportable transaction.

(e) *Pass-through items.* The determination of whether a taxpayer acted with reasonable cause and in good faith with respect to an underpayment that is related to an item reflected on the return of a pass-through entity is made on the basis of all pertinent facts and circumstances, including the taxpayer's own actions, as well as the actions of the pass-through entity.

(f) *Special rules for substantial understatement penalty attributable to tax shelter items of corporations*—(1) *In general; facts and circumstances.* The determination of whether a corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item (as defined in §1.6662–4(g)(3)) is based on all pertinent facts and circumstances. Paragraphs (f)(2), (3), and (4) of this section set forth rules that apply, in the case of a penalty attributable to a substantial understatement of income tax (within the meaning of section 6662(d)), in determining whether a corporation acted with reasonable cause and in good faith with respect to a tax shelter item.

(2) *Reasonable cause based on legal justification*—(i) *Minimum requirements.* A corporation's legal justification (as defined in paragraph (f)(2)(ii) of this section) may be taken into account, as appropriate, in establishing that the corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item only if the authority requirement of paragraph (f)(2)(i)(A) of this section and the belief requirement of paragraph (f)(2)(i)(B) of this section are satisfied (the minimum requirements). Thus, a failure to satisfy the minimum requirements will preclude a finding of reasonable cause and good faith based (in whole or in part) on the corporation's legal justification.

(A) *Authority requirement.* The authority requirement is satisfied only if there is substantial authority (within the meaning of §1.6662–4(d)) for the tax treatment of the item.

(B) *Belief requirement.* The belief requirement is satisfied only if, based on all facts and circumstances, the corporation reasonably believed, at the time the return was filed, that the tax treatment of the item was more likely than not the proper treatment. For purposes of the preceding sentence, a corporation is considered reasonably to believe that the tax treatment of an item is more likely than not the proper tax treatment if (without taking into account the possibility that a return will not be audited, that an issue will not be raised on audit, or that an issue will be settled)—

(*1*) The corporation analyzes the pertinent facts and authorities in the manner described in § 1.6662–4(d)(3)(ii), and in reliance upon that analysis, reasonably concludes in good faith that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service; or

(*2*) The corporation reasonably relies in good faith on the opinion of a professional tax advisor, if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities in the manner described in § 1.6662–4(d)(3)(ii) and unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service. (For this purpose, the requirements of paragraph (c) of this section must be met with respect to the opinion of a professional tax advisor.)

(ii) *Legal justification defined.* For purposes of this paragraph (e), *legal justification* includes any justification relating to the treatment or characterization under the Federal tax law of the tax shelter item or of the entity, plan, or arrangement that gave rise to the item. Thus, a taxpayer's belief (whether independently formed or based on the advice of others) as to the merits of the taxpayer's underlying position is a legal justification.

(3) *Minimum requirements not dispositive.* Satisfaction of the minimum requirements of paragraph (f)(2) of this section is an important factor to be considered in determining whether a corporate taxpayer acted with reasonable cause and in good faith, but is not necessarily dispositive. For example, depending on the circumstances, satisfaction of the minimum requirements may not be dispositive if the taxpayer's participation in the tax shelter lacked significant business purpose, if the taxpayer claimed tax benefits that are unreasonable in comparison to the taxpayer's investment in the tax shelter, or if the taxpayer agreed with the organizer or promoter of the tax shelter that the taxpayer would protect the confidentiality of the tax aspects of the structure of the tax shelter.

(4) *Other factors.* Facts and circumstances other than a corporation's legal justification may be taken into account, as appropriate, in determining whether the corporation acted with reasonable cause and in good faith with respect to a tax shelter item regardless of whether the minimum requirements of paragraph (f)(2) of this section are satisfied.

(g) *Tranactions between persons described in section 482 and net section 482 transfer price adjustments.* [Reserved]

(h) *Valuation misstatements of charitable deduction property*—(1) *In general.* There may be reasonable cause and good faith with respect to a portion of an underpayment that is attributable to a substantial (or gross) valuation misstatement of charitable deduction property (as defined in paragraph (h)(2) of this section) only if—

(i) The claimed value of the property was based on a qualified appraisal (as defined in paragraph (h)(2) of this section) by a qualified appraiser (as defined in paragraph (h)(2) of this section); and

(ii) In addition to obtaining a qualified appraisal, the taxpayer made a good faith investigation of the value of the contributed property.

(2) *Definitions.* For purposes of this paragraph (h):

Charitable deduction property means any property (other than money or publicly traded securities, as defined in § 1.170A–13(c)(7)(xi)) contributed by the taxpayer in a contribution for which a deduction was claimed under section 170.

Qualified appraisal means a qualified appraisal as defined in § 1.170A–13(c)(3).

Qualified appraiser means a qualified appraiser as defined in § 1.170A–13(c)(5).

(3) *Special rules.* The rules of this paragraph (h) apply regardless of whether § 1.170A–13 permits a taxpayer to claim a charitable contribution deduction for the property without obtaining a qualified appraisal. The rules of this paragraph (h) apply in addition

to the generally applicable rules concerning reasonable cause and good faith.

[T.D. 8381, 56 FR 67508, Dec. 31, 1991; T.D. 8381, 57 FR 6166, Feb. 20, 1992, as amended by T.D. 8617, 60 FR 45666, Sept. 1, 1995; T.D. 8790, 63 FR 66435, Dec. 2, 1998; T.D. 9109, 68 FR 75128, Dec. 30, 2003]

§ 1.6664–4T Reasonable cause and good faith exception to section 6662 penalties.

(a)–(e) [Reserved]

(f) *Transactions between persons described in section 482 and net section 482 transfer price adjustments*. For purposes of applying the reasonable cause and good faith exception of section 6664(c) to net section 482 adjustments, the rules of § 1.6662–6(d) apply. A taxpayer that does not satisfy the rules of § 1.6662–6(d) for a net section 482 adjustment cannot satisfy the reasonable cause and good faith exception under section 6664(c). The rules of this section apply to underpayments subject to the transactional penalty in § 1.6662–6(b). If the standards of the net section 482 penalty exclusion provisions under § 1.6662–6(d) are met with respect to such underpayments, then the taxpayer will be considered to have acted with reasonable cause and good faith for purposes of this section.

[T.D. 8656, 61 FR 4885, Feb. 9, 1996]

§ 1.6694–0 Table of contents.

This section lists the captions that appear in §§ 1.6694–1 through 1.6694–4.

(g) Effective/applicability date.

§ 1.6694–4 Extension of period of collection when tax return preparer pays 15 percent of a penalty for understatement of taxpayer's liability and certain other procedural matters.

(a) In general.

(b) Tax return preparer must bring suit in district court to determine liability for penalty.

(c) Suspension of running of period of limitations on collection.

(d) Effective/applicability date.

[T.D. 9436, 73 FR 78439, Dec. 22, 2008]

§ 1.6694–1 Section 6694 penalties applicable to tax return preparers.

(a) *Overview*—(1) *In general.* Sections 6694(a) and (b) impose penalties on tax return preparers for conduct giving rise to certain understatements of liability on a return (including an amended or adjusted return) or claim for refund. For positions other than those with respect to tax shelters (as defined in section 6662(d)(2)(C)(ii)) and reportable transactions to which section 6662A applies, the section 6694(a) penalty is imposed in an amount equal to the greater of $1,000 or 50 percent of the income derived (or to be derived) by the tax return preparer for an understatement of tax liability that is due to an undisclosed position for which the tax return preparer did not have substantial authority or due to a disclosed position for which there is no reasonable basis. For positions with respect to tax shelters (as defined in section 6662(d)(2)(C)(ii)) or reportable transactions to which section 6662A applies, the section 6694(a) penalty is imposed in an amount equal to the greater of $1,000 or 50 percent of the income derived (or to be derived) by the tax return preparer for an understatement of tax liability for which it is not reasonable to believe that the position would more likely than not be sustained on its merits. The section 6694(b) penalty is imposed in an amount equal to the greater of $5,000 or 50 percent of the income derived (or to be derived) by the tax return preparer for an understatement of liability with respect to tax that is due to a willful attempt to understate tax liability or that is due to reckless or intentional disregard of rules or regulations. Refer to § 1.6694–2 for rules relating to the penalty under section 6694(a). Refer to § 1.6694–3 for rules relating to the penalty under section 6694(b).

(2) *Date return is deemed prepared.* For purposes of the penalties under section 6694, a return or claim for refund is deemed prepared on the date it is signed by the tax return preparer. If a signing tax return preparer within the meaning of § 301.7701–15(b)(1) of this chapter fails to sign the return, the return or claim for refund is deemed prepared on the date the return or claim is filed. See § 1.6695–1 of this section. In the case of a nonsigning tax return preparer within the meaning of § 301.7701–15(b)(2) of this chapter, the relevant date is the date the nonsigning tax return preparer provides the tax advice with respect to the position giving rise to the understatement. This date will be determined based on all the facts and circumstances.

(b) *Tax return preparer*—(1) *In general.* For purposes of this section, "tax return preparer" means any person who is a tax return preparer within the meaning of section 7701(a)(36) and § 301.7701–15 of this chapter. An individual is a tax return preparer subject to section 6694 if the individual is primarily responsible for the position(s) on the return or claim for refund giving rise to an understatement. See § 301.7701–15(b)(3). There is only one individual within a firm who is primarily responsible for each position on the return or claim for refund giving rise to an understatement. In the course of identifying the individual who is primarily responsible for the position, the Internal Revenue Service (IRS) may advise multiple individuals within the firm that it may be concluded that they are the individual within the firm who is primarily responsible. In some circumstances, there may be more than one tax return preparer who is primarily responsible for the position(s) giving rise to an understatement if multiple tax return preparers are employed by, or associated with, different firms.

(2) *Responsibility of signing tax return preparer.* If there is a signing tax return preparer within the meaning of § 301.7701–15(b)(1) of this chapter within a firm, the signing tax return preparer generally will be considered the person

who is primarily responsible for all of the positions on the return or claim for refund giving rise to an understatement unless, based upon credible information from any source, it is concluded that the signing tax return preparer is not primarily responsible for the position(s) on the return or claim for refund giving rise to an understatement. In that case, a nonsigning tax return preparer within the signing tax return preparer's firm (as determined in paragraph (b)(3) of this section) will be considered the tax return preparer who is primarily responsible for the position(s) on the return or claim for refund giving rise to an understatement.

(3) *Responsibility of nonsigning tax return preparer*. If there is no signing tax return preparer within the meaning of §301.7701–15(b)(1) of this chapter for the return or claim for refund within the firm or if, after the application of paragraph (b)(2) of this section, it is concluded that the signing tax return preparer is not primarily responsible for the position, the nonsigning tax return preparer within the meaning of §301.7701–15(b)(2) of this chapter within the firm with overall supervisory responsibility for the position(s) giving rise to the understatement generally will be considered the tax return preparer who is primarily responsible for the position for purposes of section 6694 unless, based upon credible information from any source, it is concluded that another nonsigning tax return preparer within that firm is primarily responsible for the position(s) on the return or claim for refund giving rise to the understatement.

(4) *Responsibility of signing and nonsigning tax return preparer*. If the information presented would support a finding that, within a firm, either the signing tax return preparer or a nonsigning tax return preparer is primarily responsible for the position(s) giving rise to the understatement, the penalty may be assessed against either one of the individuals, but not both, as the primarily responsible tax return preparer.

(5) *Tax return preparer and firm responsibility*. To the extent provided in §§1.6694–2(a)(2) and 1.6694–3(a)(2), an individual and the firm that employs the individual, or the firm of which the individual is a partner, member, shareholder, or other equity holder, both may be subject to penalty under section 6694 with respect to the position(s) on the return or claim for refund giving rise to an understatement. If an individual (other than the sole proprietor) who is employed by a sole proprietorship is subject to penalty under section 6694, the sole proprietorship is considered a ''firm'' for purposes of this paragraph (b).

(6) *Examples*. The provisions of paragraph (b) of this section are illustrated by the following examples:

Example 1. Attorney A provides advice to Client C concerning the proper treatment of an item with respect to which all events have occurred on C's tax return. In preparation for providing that advice, A seeks advice regarding the proper treatment of the item from Attorney B, who is within the same firm as A, but A is the attorney who signs C's return as a tax return preparer. B provides advice on the treatment of the item upon which A relies. B's advice is reflected on C's tax return but no disclosure was made in accordance with §1.6694–2(d)(3). The advice constitutes preparation of a substantial portion of the return within the meaning of §301.7701–15(b)(3). The IRS later challenges the position taken on the tax return, giving rise to an understatement of liability. For purposes of the regulations under section 6694, A is initially considered the tax return preparer with respect to C's return, and the IRS advises A that A may be subject to the penalty under section 6694 with respect to C's return. Based upon information received from A or another source, it may be concluded that B, rather than A, had primary responsibility for the position taken on the return that gave rise to the understatement and may be subject to penalty under section 6694 instead of A.

Example 2. Same as *Example 1*, except that neither Attorney A nor any other source produce credible information that Attorney B had primary responsibility for the position on the return giving rise to an understatement. Attorney A is the tax return preparer who may be subject to penalty under section 6694 with respect to C's return.

Example 3. Same as *Example 1*, except that neither Attorney A nor any other attorney within A's firm signs Client C's return as a tax return preparer. Attorney B is the nonsigning tax return preparer within the firm with overall supervisory responsibility for the position giving rise to an understatement. Accordingly, B is the tax return preparer who is primarily responsible for the position on C's return giving rise to an understatement and may be subject to penalty under section 6694.

Example 4. Same as *Example 1*, except Attorney D, who works for a different firm than A, also provides advice on the same position upon which A relies. It may be concluded that D is also primarily responsible for the position on the return and may be subject to penalty under section 6694.

Example 5. Same as *Example 1*, except Attorney B is able to present credible information that A is also responsible for the position on C's return giving rise to an understatement. The IRS may conclude between A and B, the two responsible persons for the position, who is primarily responsible and may assess a section 6694 penalty against A or B, but not both, as the primarily responsible tax return preparer.

(c) *Understatement of liability.* For purposes of this section, an ''understatement of liability'' exists if, viewing the return or claim for refund as a whole, there is an understatement of the net amount payable with respect to any tax imposed by the Internal Revenue Code (Code), or an overstatement of the net amount creditable or refundable with respect to any tax imposed by the Code. The net amount payable in a taxable year with respect to the return for which the tax return preparer engaged in conduct proscribed by section 6694 is not reduced by any carryback. Tax imposed by the Code does not include additions to the tax, additional amounts, and assessable penalties imposed by subchapter 68 of the Code. Except as provided in paragraph (d) of this section, the determination of whether an understatement of liability exists may be made in a proceeding involving the tax return preparer that is separate and apart from any proceeding involving the taxpayer.

(d) *Abatement of penalty where taxpayer's liability not understated.* If a penalty under section 6694(a) or (b) concerning a return or claim for refund has been assessed against one or more tax return preparers, and if it is established at any time in a final administrative determination or a final judicial decision that there was no understatement of liability relating to the position(s) on the return or claim for refund, then—

(1) The assessment shall be abated; and

(2) If any amount of the penalty was paid, that amount shall be refunded to the person or persons who so paid, as if the payment were an overpayment of tax, without consideration of any period of limitations.

(e) *Verification of information furnished by taxpayer or other party*—(1) *In general.* For purposes of sections 6694(a) and (b) (including demonstrating that a position complied with relevant standards under section 6694(a) and demonstrating reasonable cause and good faith under §1.6694–2(e)), the tax return preparer generally may rely in good faith without verification upon information furnished by the taxpayer. A tax return preparer also may rely in good faith and without verification upon information and advice furnished by another advisor, another tax return preparer or other party (including another advisor or tax return preparer at the tax return preparer's firm). The tax return preparer is not required to audit, examine or review books and records, business operations, documents, or other evidence to verify independently information provided by the taxpayer, advisor, other tax return preparer, or other party. The tax return preparer, however, may not ignore the implications of information furnished to the tax return preparer or actually known by the tax return preparer. The tax return preparer must make reasonable inquiries if the information as furnished appears to be incorrect or incomplete. Additionally, some provisions of the Code or regulations require that specific facts and circumstances exist (for example, that the taxpayer maintain specific documents) before a deduction or credit may be claimed. The tax return preparer must make appropriate inquiries to determine the existence of facts and circumstances required by a Code section or regulation as a condition of the claiming of a deduction or credit.

(2) *Verification of information on previously filed returns.* For purposes of section 6694(a) and (b) (including meeting the reasonable to believe that the position would more likely than not be

sustained on its merits and reasonable basis standards in §§1.6694–2(b) and (d)(2), and demonstrating reasonable cause and good faith under §1.6694–2(e)), a tax return preparer may rely in good faith without verification upon a tax return that has been previously prepared by a taxpayer or another tax return preparer and filed with the IRS. For example, a tax return preparer who prepares an amended return (including a claim for refund) need not verify the positions on the original return. The tax return preparer, however, may not ignore the implications of information furnished to the tax return preparer or actually known by the tax return preparer. The tax return preparer must make reasonable inquiries if the information as furnished appears to be incorrect or incomplete. The tax return preparer must confirm that the position being relied upon has not been adjusted by examination or otherwise.

(3) *Examples.* The provisions of this paragraph (e) are illustrated by the following examples:

Example 1. During an interview conducted by Preparer E, a taxpayer stated that he had made a charitable contribution of real estate in the amount of $50,000 during the tax year, when in fact he had not made this charitable contribution. E did not inquire about the existence of a qualified appraisal or complete a Form 8283, Noncash Charitable Contributions, in accordance with the reporting and substantiation requirements under section 170(f)(11). E reported a deduction on the tax return for the charitable contribution, which resulted in an understatement of liability for tax, and signed the tax return as the tax return preparer. E is subject to a penalty under section 6694.

Example 2. While preparing the 2008 tax return for an individual taxpayer, Preparer F realizes that the taxpayer did not provide a Form 1099–INT, ''Interest Income'', for a bank account that produced significant taxable income in 2007. When F inquired about any other income, the taxpayer furnished the Form 1099–INT to F for use in preparation of the 2008 tax return. F did not know that the taxpayer owned an additional bank account that generated taxable income for 2008, and the taxpayer did not reveal this information to the tax return preparer notwithstanding F's general inquiry about any other income. F signed the taxpayer's return as the tax return preparer. F is not subject to a penalty under section 6694.

Example 3. In preparing a tax return, for purposes of determining the deductibility of a contribution by an employer for a qualified pension plan, Accountant G relies on a computation of the section 404 limit on deductible amounts made by the enrolled actuary for the plan. On the basis of this calculation, G completed and signed the tax return. It is later determined that there is an understatement of liability for tax that resulted from the overstatement of the section 404 limit on deductible amounts made by the actuary. G had no reason to believe that the actuary's calculation of the limit on deductible contributions was incorrect or incomplete, and the calculation appeared reasonable on its face. G was also not aware at the time the return was prepared of any reason why the actuary did not know all of the relevant facts or that the calculation of the limit on deductible contributions was no longer reliable due to developments in the law since the time the calculation was given. G is not subject to a penalty under section 6694. The actuary, however, may be subject to penalty under section 6694 if the calculation provided by the actuary constitutes a substantial portion of the tax return within the meaning of §301.7701–15(b)(3) of this chapter.

(f) *Income derived (or to be derived) with respect to the return or claim for refund*—(1) *In general.* For purposes of sections 6694(a) and (b), *income derived (or to be derived)* means all compensation the tax return preparer receives or expects to receive with respect to the engagement of preparing the return or claim for refund or providing tax advice (including research and consultation) with respect to the position(s) taken on the return or claim for refund that gave rise to the understatement. In the situation of a tax return preparer who is not compensated directly by the taxpayer, but rather by a firm that employs the tax return preparer or with which the tax return preparer is associated, *income derived (or to be derived)* means all compensation the tax return preparer receives from the firm that can be reasonably allocated to the engagement of preparing the return or claim for refund or providing tax advice (including research and consultation) with respect to the position(s) taken on the return or claim for refund that gave rise to the understatement. In the situation where a firm that employs the individual tax return preparer (or the firm of which the individual tax return preparer is a partner, member, shareholder, or other equity holder) is subject to a penalty under section 6694(a) or (b) pursuant to the provisions in §§1.6694–2(a)(2) or 1.6694–

3(a)(2), *income derived (or to be derived)* means all compensation the firm receives or expects to receive with respect to the engagement of preparing the return or claim for refund or providing tax advice (including research and consultation) with respect to the position(s) taken on the return or claim for refund that gave rise to the understatement.

(2) *Compensation*—(i) *Multiple engagements.* For purposes of applying paragraph (f)(1) of this section, if the tax return preparer or the tax return preparer's firm has multiple engagements related to the same return or claim for refund, only those engagements relating to the position(s) taken on the return or claim for refund that gave rise to the understatement are considered for purposes of calculating the income derived (or to be derived) with respect to the return or claim for refund.

(ii) *Reasonable allocation.* For purposes of applying paragraph (f)(1) of this section, only compensation for tax advice that is given with respect to events that have occurred at the time the advice is rendered and that relates to the position(s) giving rise to the understatement will be taken into account for purposes of calculating the section 6694(a) and (b) penalties. If a lump sum fee is received that includes amounts not taken into account under the preceding sentence, the amount of income derived will be based on a reasonable allocation of the lump sum fee between the tax advice giving rise to the penalty and the advice that does not give rise to the penalty.

(iii) *Fee refunds.* For purposes of applying paragraph (f)(1) of this section, a refund to the taxpayer of all or part of the amount paid to the tax return preparer or the tax return preparer's firm will not reduce the amount of the section 6694 penalty assessed. A refund in this context does not include a discounted fee or alternative billing arrangement for the services provided.

(iv) *Reduction of compensation.* For purposes of applying paragraph (f)(1) of this section, it may be concluded based upon information provided by the tax return preparer or the tax return preparer's firm that an appropriate allocation of compensation attributable to the position(s) giving rise to the understatement on the return or claim for refund is less than the total amount of compensation associated with the engagement. For example, the number of hours of the engagement spent on the position(s) giving rise to the understatement may be less than the total hours associated with the engagement. If this is concluded, the amount of the penalty will be calculated based upon the compensation attributable to the position(s) giving rise to the understatement. Otherwise, the total amount of compensation from the engagement will be the amount of income derived for purposes of calculating the penalty under section 6694.

(3) *Individual and firm allocation.* If both an individual within a firm and a firm that employs the individual (or the firm of which the individual is a partner, member, shareholder, or other equity holder) are subject to a penalty under section 6694(a) or (b) pursuant to the provisions in §§ 1.6694–2(a)(2) or 1.6694–3(a)(2), the amount of penalties assessed against the individual and the firm shall not exceed 50 percent of the income derived (or to be derived) by the firm from the engagement of preparing the return or claim for refund or providing tax advice (including research and consultation) with respect to the position(s) taken on the return or claim for refund that gave rise to the understatement. The portion of the total amount of the penalty assessed against the individual tax return preparer shall not exceed 50 percent of the individual's compensation as determined under paragraphs (f)(1) and (2) of this section.

(4) *Examples.* The provisions of this paragraph (f) are illustrated by the following examples:

Example 1. Signing Tax Return Preparer H is engaged by a taxpayer and paid a total of $21,000. Of this amount, $20,000 relates to research and consultation regarding a transaction that is later reported on a return, and $1,000 is for the activities relating to the preparation of the return. Based on H's hourly rates, a reasonable allocation of the amount of compensation related to the advice rendered prior to the occurrence of events that are the subject of the advice is $5,000. The remaining compensation of $16,000 is considered to be compensation related to the advice rendered after the occurrence of events that are the subject of the advice and return preparation. The income derived by H with respect to the return for purposes of computing the penalty under section 6694(a) is $16,000, and the amount of the penalty imposed under section 6694(a) is $8,000.

Example 2. Accountants I, J, and K are employed by Firm L. I is a principal manager of Firm L and provides corporate tax advice for the taxpayer after all events have occurred subject to an engagement for corporate tax advice. J provides international tax advice for the taxpayer after all events have occurred subject to a different engagement for international tax advice. K prepares and signs the taxpayer's return under a general tax services engagement. I's advice is the source of an understatement on the return and the advice constitutes preparation of a substantial portion of the return within the meaning of §301.7701–15(b) of this chapter. I is the nonsigning tax return preparer within the firm with overall supervisory responsibility for the position on the taxpayer's return giving rise to an understatement. Thus, I is the tax return preparer who is primarily responsible for the position on the taxpayer's return giving rise to the understatement. Because K's signature as the signing tax return preparer is on the return, the IRS advises K that K may be subject to the section 6694(a) penalty. K provides credible information that I is the tax return preparer with primary responsibility for the position that gave rise to the understatement. The IRS, therefore, assesses the section 6694 penalty against I. The portion of the total amount of the penalty allocable to I does not exceed 50 percent of that part of I's compensation that is attributable to the corporate tax advice engagement. In the event that Firm L is also liable under the provisions in §1.6694–2(a)(2), the IRS assesses the section 6694 penalty in an amount not exceeding 50 percent of Firm L's firm compensation based on the engagement relating to the corporate tax advice services provided by I where there is no applicable reduction in compensation pursuant to §1.6694–1(f)(2)(iii).

Example 3. Same facts as *Example 2,* except that I provides the advice on the corporate matter when the events have not yet occurred. I's advice is the cause of an understatement position on the return, but I is not a tax return preparer pursuant to §301.7701–15(b)(2) or (3) of this chapter. K is not limited to reliance on persons who provide post-transactional advice if such reliance is reasonable and in good faith. Further, K has reasonable cause because K relied on I for the advice on the corporate tax matter. I, K and Firm L are not liable for the section 6694 penalty.

Example 4. Attorney M is an employee of Firm N with a salary of $75,000 per year. M performs tax preparation work for Client O. Client O's return contains a position that results in an understatement subject to the section 6694 penalty. M spent 100 hours on the position (out of a total 2,000 billed during the year). The total fees earned by Firm N with respect to the position reflected on Client O's return are $50,000. If M is subject to the penalty, the penalty amount computed under the 50 percent of income standard is .5 × (100/2,000) × $75,000 = $1,875. If Firm N is subject to the penalty, the penalty amount computed under the 50% of income standard is .5 × $50,000 = $25,000, less any penalty amount imposed against M. If a penalty of $1,875 was assessed against M and Firm N was subject to the penalty, a penalty of $23,125 would be the amount of penalty assessed against Firm N.

(g) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78439, Dec. 22, 2008, as amended at 74 FR 5104, Jan. 29, 2009]

§ 1.6694–2 Penalty for understatement due to an unreasonable position.

(a) *In general*—(1) *Proscribed conduct.* Except as otherwise provided in this section, a tax return preparer is liable for a penalty under section 6694(a) equal to the greater of $1,000 or 50 percent of the income derived (or to be derived) by the tax return preparer for any return or claim for refund that it prepares that results in an understatement of liability due to a position if the tax return preparer knew (or reasonably should have known) of the position and either—

(i) The position is with respect to a tax shelter (as defined in section 6662(d)(2)(C)(ii)) or a reportable transaction to which section 6662A applies, and it was not reasonable to believe that the position would more likely than not be sustained on its merits;

(ii) The position was not disclosed as provided in this section, the position is not with respect to a tax shelter (as defined in section 6662(d)(2)(C)(ii)) or a reportable transaction to which section 6662A applies, and there was not substantial authority for the position; or

(iii) The position (other than a position with respect to a tax shelter or a reportable transaction to which section 6662A applies) was disclosed as provided in this section but there was no reasonable basis for the position.

(2) *Special rule for corporations, partnerships, and other firms.* A firm that

employs a tax return preparer subject to a penalty under section 6694(a) (or a firm of which the individual tax return preparer is a partner, member, shareholder or other equity holder) is also subject to penalty if, and only if—

(i) One or more members of the principal management (or principal officers) of the firm or a branch office participated in or knew of the conduct proscribed by section 6694(a);

(ii) The corporation, partnership, or other firm entity failed to provide reasonable and appropriate procedures for review of the position for which the penalty is imposed; or

(iii) The corporation, partnership, or other firm entity disregarded its reasonable and appropriate review procedures through willfulness, recklessness, or gross indifference (including ignoring facts that would lead a person of reasonable prudence and competence to investigate or ascertain) in the formulation of the advice, or the preparation of the return or claim for refund, that included the position for which the penalty is imposed.

(b) *Reasonable to believe that the position would more likely than not be sustained on its merits*—(1) *In general.* If a position is with respect to a tax shelter (as defined in section 6662(d)(2)(C)(ii)) or a reportable transaction to which section 6662A applies, it is ''reasonable to believe that a position would more likely than not be sustained on its merits'' if the tax return preparer analyzes the pertinent facts and authorities and, in reliance upon that analysis, reasonably concludes in good faith that the position has a greater than 50 percent likelihood of being sustained on its merits. In reaching this conclusion, the possibility that the position will not be challenged by the Internal Revenue Service (IRS) (for example, because the taxpayer's return may not be audited or because the issue may not be raised on audit) is not to be taken into account. The analysis prescribed by §1.6662–4(d)(3)(ii) (or any successor provision) for purposes of determining whether substantial authority is present applies for purposes of determining whether the more likely than not standard is satisfied. Whether a tax return preparer meets this standard will be determined based upon all facts and circumstances, including the tax return preparer's diligence. In determining the level of diligence in a particular situation, the tax return preparer's experience with the area of Federal tax law and familiarity with the taxpayer's affairs, as well as the complexity of the issues and facts, will be taken into account. A tax return preparer may reasonably believe that a position more likely than not would be sustained on its merits despite the absence of other types of authority if the position is supported by a well-reasoned construction of the applicable statutory provision. For purposes of determining whether it is reasonable to believe that the position would more likely than not be sustained on the merits, a tax return preparer may rely in good faith without verification upon information furnished by the taxpayer and information and advice furnished by another advisor, another tax return preparer, or other party (including another advisor or tax return preparer at the tax return preparer's firm), as provided in §§1.6694–1(e) and 1.6694–2(e)(5).

(2) *Authorities.* The authorities considered in determining whether a position satisfies the more likely than not standard are those authorities provided in §1.6662–4(d)(3)(iii) (or any successor provision).

(3) *Written determinations.* The tax return preparer may avoid the section 6694(a) penalty by taking the position that the tax return preparer reasonably believed that the taxpayer's position satisfies the ''more likely than not'' standard if the taxpayer is the subject of a ''written determination'' as provided in §1.6662–4(d)(3)(iv)(A).

(4) *Taxpayer's jurisdiction.* The applicability of court cases to the taxpayer by reason of the taxpayer's residence in a particular jurisdiction is not taken into account in determining whether it is reasonable to believe that the position would more likely than not be sustained on the merits. Notwithstanding the preceding sentence, the tax return preparer may reasonably believe that the position would more likely than not be sustained on the merits if the position is supported by controlling precedent of a United States Court of Appeals to which the taxpayer has a

right of appeal with respect to the item.

(5) *When ''more likely than not'' standard must be satisfied.* For purposes of this section, the requirement that a position satisfies the ''more likely than not'' standard must be satisfied on the date the return is deemed prepared, as prescribed by § 1.6694–1(a)(2).

(c) [Reserved]

(d) *Exception for adequate disclosure of positions with a reasonable basis*—(1) *In general.* The section 6694(a) penalty will not be imposed on a tax return preparer if the position taken (other than a position with respect to a tax shelter or a reportable transaction to which section 6662A applies) has a reasonable basis and is adequately disclosed within the meaning of paragraph (c)(3) of this section. For an exception to the section 6694(a) penalty for reasonable cause and good faith, see paragraph (e) of this section.

(2) *Reasonable basis.* For purposes of this section, ''reasonable basis'' has the same meaning as in § 1.6662–3(b)(3) or any successor provision of the accuracy-related penalty regulations. For purposes of determining whether the tax return preparer has a reasonable basis for a position, a tax return preparer may rely in good faith without verification upon information furnished by the taxpayer and information and advice furnished by another advisor, another tax return preparer, or other party (including another advisor or tax return preparer at the tax return preparer's firm), as provided in §§ 1.6694–1(e) and 1.6694–2(e)(5).

(3) *Adequate disclosure*—(i) *Signing tax return preparers.* In the case of a signing tax return preparer within the meaning of § 301.7701–15(b)(1) of this chapter, disclosure of a position (other than a position with respect to a tax shelter or a reportable transaction to which section 6662A applies) for which there is a reasonable basis but for which there is not substantial authority is adequate if the tax return preparer meets any of the following standards:

(A) The position is disclosed in accordance with § 1.6662–4(f) (which permits disclosure on a properly completed and filed Form 8275, ''Disclosure Statement,'' or Form 8275–R, ''Regulation Disclosure Statement,'' as appropriate, or on the tax return in accordance with the annual revenue procedure described in § 1.6662–4(f)(2));

(B) The tax return preparer provides the taxpayer with the prepared tax return that includes the disclosure in accordance with § 1.6662–4(f); or

(C) For returns or claims for refund that are subject to penalties pursuant to section 6662 other than the accuracy-related penalty attributable to a substantial understatement of income tax under section 6662(b)(2) and (d), the tax return preparer advises the taxpayer of the penalty standards applicable to the taxpayer under section 6662. The tax return preparer must also contemporaneously document the advice in the tax return preparer's files.

(ii) *Nonsigning tax return preparers.* In the case of a nonsigning tax return preparer within the meaning of § 301.7701–15(b)(2) of this chapter, disclosure of a position (other than a position with respect to a tax shelter or a reportable transaction to which section 6662A applies) that satisfies the reasonable basis standard but does not satisfy the substantial authority standard is adequate if the position is disclosed in accordance with § 1.6662–4(f) (which permits disclosure on a properly completed and filed Form 8275 or Form 8275–R, as applicable, or on the return in accordance with an annual revenue procedure described in § 1.6662–4(f)(2)). In addition, disclosure of a position is adequate in the case of a nonsigning tax return preparer if, with respect to that position, the tax return preparer complies with the provisions of paragraph (c)(3)(ii)(A) or (B) of this section, whichever is applicable.

(A) *Advice to taxpayers.* If a nonsigning tax return preparer provides advice to the taxpayer with respect to a position (other than a position with respect to a tax shelter or a reportable transaction to which section 6662A applies) for which there is a reasonable basis but for which there is not substantial authority, disclosure of that position is adequate if the tax return preparer advises the taxpayer of any opportunity to avoid penalties under section 6662 that could apply to the position, if relevant, and of the standards for disclosure to the extent applicable.

The tax return preparer must also contemporaneously document the advice in the tax return preparer's files. The contemporaneous documentation should reflect that the affected taxpayer has been advised by a tax return preparer in the firm of the potential penalties and the opportunity to avoid penalty through disclosure.

(B) *Advice to another tax return preparer.* If a nonsigning tax return preparer provides advice to another tax return preparer with respect to a position (other than a position with respect to a tax shelter or a reportable transaction to which section 6662A applies) for which there is a reasonable basis but for which there is not substantial authority, disclosure of that position is adequate if the tax return preparer advises the other tax return preparer that disclosure under section 6694(a) may be required. The tax return preparer must also contemporaneously document the advice in the tax return preparer's files. The contemporaneous documentation should reflect that the tax return preparer outside the firm has been advised that disclosure under section 6694(a) may be required. In addition, disclosure of a position is adequate in the case of a nonsigning tax return preparer if, with respect to that position, the tax return preparer complies with the provisions of paragraph (d)(3)(ii)(A) or (B) of this section, whichever is applicable.

(iii) *Requirements for advice.* For purposes of satisfying the disclosure standards of paragraphs (d)(3)(i)(C) and (ii) of this section, each return position for which there is a reasonable basis but for which there is not substantial authority must be addressed by the tax return preparer. The advice to the taxpayer with respect to each position, therefore, must be particular to the taxpayer and tailored to the taxpayer's facts and circumstances. The tax return preparer is required to contemporaneously document the fact that the advice was provided. There is no general pro forma language or special format required for a tax return preparer to comply with these rules. A general disclaimer will not satisfy the requirement that the tax return preparer provide and contemporaneously document advice regarding the likelihood that a position will be sustained on the merits and the potential application of penalties as a result of that position. Tax return preparers, however, may rely on established forms or templates in advising clients regarding the operation of the penalty provisions of the Internal Revenue Code. A tax return preparer may choose to comply with the documentation standard in one document addressing each position or in multiple documents addressing all of the positions.

(iv) *Pass-through entities.* Disclosure in the case of items attributable to a pass-through entity is adequate if made at the entity level in accordance with the rules in §1.6662–4(f)(5) or at the entity level in accordance with the rules in paragraphs (d)(3)(i) or (ii) of this section.

(v) *Examples.* The provisions of paragraph (d)(3) of this section are illustrated by the following examples:

Example 1. An individual taxpayer hires Accountant R to prepare its income tax return. A particular position taken on the tax return does not have substantial authority although there is a reasonable basis for the position. The position is not with respect to a tax shelter or a reportable transaction to which section 6662A applies. R prepares and signs the tax return and provides the taxpayer with the prepared tax return that includes the Form 8275, ''Disclosure Statement,'' disclosing the position taken on the tax return. The individual taxpayer signs and files the tax return without disclosing the position. The IRS later challenges the position taken on the tax return, resulting in an understatement of liability. R is not subject to a penalty under section 6694.

Example 2. Attorney S advises a large corporate taxpayer concerning the proper treatment of complex entries on the corporate taxpayer's tax return. S has reason to know that the tax attributable to the entries is a substantial portion of the tax required to be shown on the tax return within the meaning of §301.7701–15(b)(3). When providing the advice, S concludes that one position does not have substantial authority, although the position meets the reasonable basis standard. The position is not with respect to a tax shelter or a reportable transaction to which section 6662A applies. S advises the corporate taxpayer that the position lacks substantial authority and the taxpayer may be subject to an accuracy-related penalty under section 6662 unless the position is disclosed in a disclosure statement included in the return. S also documents the fact that this advice was contemporaneously provided to the corporate taxpayer at the time the advice was provided. Neither S nor any other attorney within S's firm signs the corporate taxpayer's return as a tax return preparer, but the advice by S constitutes preparation of a substantial portion of the tax return, and S is the individual with overall supervisory responsibility for the position giving rise to the understatement. Thus, S is a tax return preparer for purposes of section 6694. S, however, will not be subject to a penalty under section 6694.

(e) *Exception for reasonable cause and good faith.* The penalty under section 6694(a) will not be imposed if, considering all the facts and circumstances, it is determined that the understatement was due to reasonable cause and that the tax return preparer acted in good faith. Factors to consider include:

(1) *Nature of the error causing the understatement.* The error resulted from a provision that was complex, uncommon, or highly technical, and a competent tax return preparer of tax returns or claims for refund of the type at issue reasonably could have made the error. The reasonable cause and good faith exception, however, does not apply to an error that would have been apparent from a general review of the return or claim for refund by the tax return preparer.

(2) *Frequency of errors.* The understatement was the result of an isolated error (such as an inadvertent mathematical or clerical error) rather than a number of errors. Although the reasonable cause and good faith exception generally applies to an isolated error, it does not apply if the isolated error is so obvious, flagrant, or material that it should have been discovered during a review of the return or claim for refund. Furthermore, the reasonable cause and good faith exception does not apply if there is a pattern of errors on a return or claim for refund even though any one error, in isolation, would have qualified for the reasonable cause and good faith exception.

(3) *Materiality of errors.* The understatement was not material in relation to the correct tax liability. The reasonable cause and good faith exception generally applies if the understatement is of a relatively immaterial amount. Nevertheless, even an immaterial understatement may not qualify for the reasonable cause and good faith exception if the error or errors creating the understatement are sufficiently obvious or numerous.

(4) *Tax return preparer's normal office practice.* The tax return preparer's normal office practice, when considered together with other facts and circumstances, such as the knowledge of the tax return preparer, indicates that the error in question would occur rarely and the normal office practice was followed in preparing the return or claim for refund in question. Such a normal office practice must be a system for promoting accuracy and consistency in the preparation of returns or claims for refund and generally would include, in the case of a signing tax return preparer, checklists, methods for obtaining necessary information from the taxpayer, a review of the prior year's return, and review procedures. Notwithstanding these rules, the reasonable cause and good faith exception does not apply if there is a flagrant error on a return or claim for refund, a pattern of errors on a return or claim for refund, or a repetition of the same or similar errors on numerous returns or claims for refund.

(5) *Reliance on advice of others.* For purposes of demonstrating reasonable cause and good faith, a tax return preparer may rely without verification upon advice and information furnished by the taxpayer and information and advice furnished by another advisor, another tax return preparer or other party, as provided in §1.6694–1(e). The tax return preparer may rely in good faith on the advice of, or schedules or other documents prepared by, the taxpayer, another advisor, another tax return preparer, or other party (including another advisor or tax return preparer at the tax return preparer's firm), who the tax return preparer had reason to believe was competent to render the advice or other information. The advice or information may be written or oral, but in either case the burden of establishing that the advice or information was received is on the tax return preparer. A tax return preparer is not considered to have relied in good faith if—

(i) The advice or information is unreasonable on its face;

(ii) The tax return preparer knew or should have known that the other party providing the advice or information was not aware of all relevant facts; or

(iii) The tax return preparer knew or should have known (given the nature of the tax return preparer's practice), at the time the return or claim for refund was prepared, that the advice or information was no longer reliable due to developments in the law since the time the advice was given.

(6) *Reliance on generally accepted administrative or industry practice.* The tax return preparer reasonably relied in good faith on generally accepted administrative or industry practice in taking the position that resulted in the understatement. A tax return preparer is not considered to have relied in good faith if the tax return preparer knew or should have known (given the nature of the tax return preparer's practice), at the time the return or claim for refund was prepared, that the administrative or industry practice was no longer reliable due to developments in the law or IRS administrative practice since the time the practice was developed.

(f) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78442, Dec. 22, 2008, as amended at 74 FR 5104, Jan. 29, 2009]

§ 1.6694–3 Penalty for understatement due to willful, reckless, or intentional conduct.

(a) *In general*—(1) *Proscribed conduct.* A tax return preparer is liable for a penalty under section 6694(b) equal to the greater of $5,000 or 50 percent of the income derived (or to be derived) by the tax return preparer if any part of an understatement of liability for a return or claim for refund that is prepared is due to—

(i) A willful attempt by a tax return preparer to understate in any manner the liability for tax on the return or claim for refund; or

(ii) Any reckless or intentional disregard of rules or regulations by a tax return preparer.

(2) *Special rule for corporations, partnerships, and other firms.* A firm that employs a tax return preparer subject to a penalty under section 6694(b) (or a firm of which the individual tax return preparer is a partner, member, shareholder or other equity holder) is also subject to penalty if, and only if—

(i) One or more members of the principal management (or principal officers) of the firm or a branch office participated in or knew of the conduct proscribed by section 6694(b);

(ii) The corporation, partnership, or other firm entity failed to provide reasonable and appropriate procedures for review of the position for which the penalty is imposed; or

(iii) The corporation, partnership, or other firm entity disregarded its reasonable and appropriate review procedures through willfulness, recklessness, or gross indifference (including ignoring facts that would lead a person of reasonable prudence and competence to investigate or ascertain) in the formulation of the advice, or the preparation of the return or claim for refund, that included the position for which the penalty is imposed.

(b) *Willful attempt to understate liability.* A preparer is considered to have willfully attempted to understate liability if the preparer disregards, in an attempt wrongfully to reduce the tax liability of the taxpayer, information furnished by the taxpayer or other persons. For example, if a preparer disregards information concerning certain items of taxable income furnished by the taxpayer or other persons, the preparer is subject to the penalty. Similarly, if a taxpayer states to a preparer that the taxpayer has only two dependents, and the preparer reports six dependents on the return, the preparer is subject to the penalty.

(c) *Reckless or intentional disregard.* (1) Except as provided in paragraphs (c)(2) and (c)(3) of this section, a preparer is considered to have recklessly or intentionally disregarded a rule or regulation if the preparer takes a position on the return or claim for refund that is contrary to a rule or regulation (as defined in paragraph (f) of this section) and the preparer knows of, or is reckless in not knowing of, the rule or regulation in question. A preparer is reckless in not knowing of a rule or regulation if the preparer makes little or no effort to determine whether a rule or regulation exists, under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable preparer would observe in the situation.

(2) A tax return preparer is not considered to have recklessly or intentionally disregarded a rule or regulation if the position contrary to the rule or regulation has a reasonable basis as defined in §1.6694–2(d)(2) and is adequately disclosed in accordance with §§1.6694–2(d)(3)(i)(A) or (C) or 1.6694–2(d)(3)(ii). In the case of a position contrary to a regulation, the position must represent a good faith challenge to the validity of the regulation and, when disclosed in accordance with §§1.6694–2(d)(3)(i)(A) or (C) or 1.6694–2(d)(3)(ii), the tax return preparer must identify the regulation being challenged. For purposes of this section, disclosure on the return in accordance with an annual revenue procedure under §1.6662–4(f)(2) is not applicable.

(3) In the case of a position contrary to a revenue ruling or notice (other than a notice of proposed rulemaking) published by the Internal Revenue Service in the Internal Revenue Bulletin, a tax return preparer also is not considered to have recklessly or intentionally disregarded the ruling or notice if the position meets the substantial authority standard described in §1.6662–4(d) and is not with respect to a reportable transaction to which section 6662A applies.

(d) *Examples*. The provisions of paragraphs (b) and (c) of this section are illustrated by the following examples:

Example 1. A taxpayer provided Preparer T with detailed check registers reflecting personal and business expenses. One of the expenses was for domestic help, and this expense was identified as personal on the check register. T knowingly deducted the expenses of the taxpayer's domestic help as wages paid in the taxpayer's business. T is subject to the penalty under section 6694(b).

Example 2. A taxpayer provided Preparer U with detailed check registers to compute the taxpayer's expenses. U, however, knowingly overstated the expenses on the return. After adjustments by the examiner, the tax liability increased significantly. Because U disregarded information provided in the check registers, U is subject to the penalty under section 6694(b).

Example 3. Preparer V prepares a taxpayer's return in 2009 and encounters certain expenses incurred in the purchase of a business. Final regulations provide that such expenses incurred in the purchase of a business must be capitalized. One U.S. Tax Court case decided in 2006 has expressly invalidated that portion of the regulations. There are no courts that ruled favorably with respect to the validity of that portion of the regulations and there are no other authorities existing on the issue. Under these facts, V will have a reasonable basis for the position as defined in §1.6694–2(d)(2) and will not be subject to the section 6694(b) penalty if the position is adequately disclosed in accordance with paragraph (c)(2) of this section because the position represents a good faith challenge to the validity of the regulations.

(e) *Rules or regulations*. The term *rules or regulations* includes the provisions of the Internal Revenue Code (Code), temporary or final Treasury regulations issued under the Code, and revenue rulings or notices (other than notices of proposed rulemaking) issued by the Internal Revenue Service and published in the Internal Revenue Bulletin.

(f) *Section 6694(b) penalty reduced by section 6694(a) penalty*. The amount of any penalty to which a tax return preparer may be subject under section 6694(b) for a return or claim for refund is reduced by any amount assessed and collected against the tax return preparer under section 6694(a) for the same position on a return or claim for refund.

(g) *Effective/applicability date*. This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

(h) *Burden of proof*. In any proceeding with respect to the penalty imposed by section 6694(b), the Government bears the burden of proof on the issue of whether the preparer willfully attempted to understate the liability for tax. See section 7427. The preparer bears the burden of proof on such other issues as whether—

(1) The preparer recklessly or intentionally disregarded a rule or regulation;

(2) A position contrary to a regulation represents a good faith challenge to the validity of the regulation; and

(3) Disclosure was adequately made in accordance with paragraph (e) of this section.

[T.D. 8382, 56 FR 67518, Dec. 31, 1991, as amended by T.D. 9436, 73 FR 78445, Dec. 22, 2008; 74 FR 5104, Jan. 29, 2009]

§ 1.6694–4 Extension of period of collection when tax return preparer pays 15 percent of a penalty for understatement of taxpayer's liability and certain other procedural matters.

(a) *In general.* (1) The Internal Revenue Service (IRS) will investigate the preparation by a tax return preparer of a return of tax under the Internal Revenue Code (Code) or claim for refund of tax under the Code as described in §301.7701–15(b)(4) of this chapter, and will send a report of the examination to the tax return preparer before the assessment of either—

(i) A penalty for understating tax liability due to a position for which either it was not reasonable to believe that the position would more likely than not be sustained on its merits under section 6694(a) or no substantial authority, as applicable (or not a reasonable basis for disclosed positions); or

(ii) A penalty for willful understatement of liability or reckless or intentional disregard of rules or regulations under section 6694(b).

(2) Unless the period of limitations (if any) under section 6696(d) may expire without adequate opportunity for assessment, the IRS will also send, before assessment of either penalty, a 30-day letter to the tax return preparer notifying him of the proposed penalty or penalties and offering an opportunity to the tax return preparer to request further administrative consideration and a final administrative determination by the IRS concerning the assessment. If the tax return preparer then makes a timely request, assessment may not be made until the IRS makes a final administrative determination adverse to the tax return preparer.

(3) If the IRS assesses either of the two penalties described in section 6694(a) and section 6694(b), it will send to the tax return preparer a statement of notice and demand, separate from any notice of a tax deficiency, for payment of the amount assessed.

(4) Within 30 days after the day on which notice and demand of either of the two penalties described in section 6694(a) and section 6694(b) is made against the tax return preparer, the tax return preparer must either—

(i) Pay the entire amount assessed (and may file a claim for refund of the amount paid at any time not later than 3 years after the date of payment); or

(ii) Pay an amount which is not less than 15 percent of the entire amount assessed with respect to each return or claim for refund and file a claim for refund of the amount paid.

(5) If the tax return preparer pays an amount and files a claim for refund under paragraph (a)(4)(ii) of this section, the IRS may not make, begin, or prosecute a levy or proceeding in court for collection of the unpaid remainder of the amount assessed until the later of—

(i) A date which is more than 30 days after the earlier of—

(A) The day on which the tax return preparer's claim for refund is denied; or

(B) The expiration of 6 months after the day on which the tax return preparer filed the claim for refund; and

(ii) Final resolution of any proceeding begun as provided in paragraph (b) of this section.

(6) The IRS may counterclaim in any proceeding begun as provided in paragraph (b) of this section for the unpaid remainder of the amount assessed. Final resolution of a proceeding includes any settlement between the IRS and the tax return preparer, any final determination by a court (for which the period for appeal, if any, has expired) and, generally, the types of determinations provided under section 1313(a) (relating to taxpayer deficiencies). Notwithstanding section 7421(a) (relating to suits to restrain assessment or collection), the beginning of a levy or proceeding in court by the IRS in contravention of paragraph (a)(5) of this section may be enjoined by a proceeding in the proper court.

(b) *Preparer must bring suit in district court to determine liability for penalty.* The IRS may proceed with collection of the amount of the penalty not paid under paragraph (a)(4)(ii) of this section if the preparer fails to begin a proceeding for refund in the appropriate United States district court within 30 days after the earlier of—

(1) The day on which the preparer's claim for refund filed under paragraph (a)(4)(ii) of this section is denied; or

(2) The expiration of 6 months after the day on which the preparer filed the claim for refund.

(c) *Suspension of running of period of limitations on collection.* The running of the period of limitations provided in section 6502 on the collection by levy or by a proceeding in court of the unpaid amount of a penalty or penalties described in section 6694(a) or section 6694(b) is suspended for the period during which the IRS, under paragraph (a)(5) of this section, may not collect the unpaid amount of the penalty or penalties by levy or a proceeding in court.

(d) *Effective/applicability date.* This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78446, Dec. 22, 2008]

§ 1.6695–1 Other assessable penalties with respect to the preparation of tax returns for other persons.

(a) *Failure to furnish copy to taxpayer.* (1) A person who is a signing tax return preparer as described in § 301.7701–15(b)(1) of this chapter of any return of tax or claim for refund of tax under the Internal Revenue Code (Code), and who fails to satisfy the requirements imposed by section 6107(a) and § 1.6107–1(a) to furnish a copy of the return or claim for refund to the taxpayer (or nontaxable entity), shall be subject to a penalty of $50 for such failure, with a maximum penalty of $25,000 per person imposed with respect to each calendar year, unless it is shown that the failure is due to reasonable cause and not due to willful neglect.

(2) No penalty may be imposed under section 6695(a) and paragraph (a)(1) of this section upon a tax return preparer who furnishes a copy of the return or claim for refund to taxpayers who—

(i) Hold an elected or politically appointed position with the government of the United States or a state or political subdivision thereof; and

(ii) In order faithfully to carry out their official duties, have so arranged their affairs that they have less than full knowledge of the property that they hold or of the debts for which they are responsible, if information is deleted from the copy in order to preserve or maintain this arrangement.

(b) *Failure to sign return.* (1) An individual who is a signing tax return preparer as described in § 301.7701–15(b)(1) of this chapter with respect to a return of tax or claim for refund of tax under the Code as described in § 301.7701–15(b)(4) that is not signed electronically shall sign the return or claim for refund after it is completed and before it is presented to the taxpayer (or nontaxable entity) for signature. For rules covering electronically signed returns, see paragraph (b)(2) of this section. If the signing tax return preparer is unavailable for signature, another tax return preparer shall review the entire preparation of the return or claim for refund, and then shall sign the return or claim for refund. The tax return preparer shall sign the return in the manner prescribed by the Commissioner in forms, instructions, or other appropriate guidance.

(2) In the case of electronically signed tax returns, the signing tax return preparer need not sign the return prior to presenting a completed copy of the return to the taxpayer. The signing tax return preparer, however, must furnish all of the information that will be transmitted as the electronically signed tax return to the taxpayer contemporaneously with furnishing the Form 8879, ''IRS e-file Signature Authorization,'' or other similar Internal Revenue Service (IRS) e-file signature form. The information may be furnished on a replica of an official form. The signing tax return preparer shall electronically sign the return in the manner prescribed by the Commissioner in forms, instructions, or other appropriate guidance.

(3) An individual required by this paragraph (b) to sign a return or claim for refund shall be subject to a penalty of $50 for each failure to sign, with a maximum of $25,000 per person imposed with respect to each calendar year, unless it is shown that the failure is due to reasonable cause and not due to

willful neglect. If the tax return preparer asserts reasonable cause for failure to sign, the IRS will require a written statement to substantiate the tax return preparer's claim of reasonable cause. For purposes of this paragraph (b), reasonable cause is a cause that arises despite ordinary care and prudence exercised by the individual tax return preparer.

(4) *Examples*. The application of this paragraph (b) is illustrated by the following examples:

Example 1. Law Firm A employs B, a lawyer, to prepare for compensation estate tax returns and claims for refund of taxes. Firm A is engaged by C to prepare a Federal estate tax return. Firm A assigns B to prepare the return. B obtains the information necessary for completing the return from C and makes determinations with respect to the proper application of the tax laws to such information in order to determine the estate's tax liability. B then forwards such information to D, a computer tax service that performs the mathematical computations and prints the return by means of computer processing. D then sends the completed estate tax return to B who reviews the accuracy of the return. B is the individual tax return preparer who is primarily responsible for the overall accuracy of the estate tax return. B must sign the return as tax return preparer in order to not be subject to the section 6695(b) penalty.

Example 2. Partnership E is a national accounting firm that prepares returns and claims for refund of taxes for compensation. F and G, employees of Partnership E, are involved in preparing the Form 990–T, Exempt Organization Business Income Tax Return, for H, a tax exempt organization. After they complete the return, including the gathering of the necessary information, analyzing the proper application of the tax laws to such information, and the performance of the necessary mathematical computations, I, a supervisory employee of Partnership E, reviews the return. As part of this review, I reviews the information provided and the application of the tax laws to this information. The mathematical computations and carried-forward amounts are reviewed by J, an employee of Partnership E. The policies and practices of Partnership E require that K, a partner, finally review the return. The scope of K's review includes reviewing the information provided and applying to this information his knowledge of H's affairs, observing that Partnership E's policies and practices have been followed, and making the final determination with respect to the proper application of the tax laws to determine H's tax liability. K may or may not exercise these responsibilities, or may exercise them to a greater or lesser extent, depending on the degree of complexity of the return, his confidence in I (or F and G), and other factors. K is the individual tax return preparer who is primarily responsible for the overall accuracy of H's return. K must sign the return as tax return preparer in order to not be subject to the section 6695(b) penalty.

Example 3. L corporation maintains an office in Seattle, Washington, for the purpose of preparing partnership returns for compensation. L makes compensatory arrangements with individuals (but provides no working facilities) in several states to collect information from partners of a partnership and to make decisions with respect to the proper application of the tax laws to the information in order to prepare the partnership return and calculate the partnership's distributive items. M, an individual, who has such an arrangement in Los Angeles with L, collects information from N, the general partner of a partnership, and completes a worksheet kit supplied by L that is stamped with M's name and an identification number assigned to M by L. In this process, M classifies this information in appropriate categories for the preparation of the partnership return. The completed worksheet kit signed by M is then mailed to L. O, an employee in L's office, reviews the worksheet kit to make sure it was properly completed. O does not review the information obtained from N for its validity or accuracy. O may, but did not, make the final decision with respect to the proper application of tax laws to the information provided. The data from the worksheet is entered into a computer and the return form is completed. The return is prepared for submission to N with filing instructions. M is the individual tax return preparer primarily responsible for the overall accuracy of the partnership return. M must sign the return as tax return preparer in order to not be subject to the section 6695(b) penalty.

Example 4. P employs R, S, and T to prepare gift tax returns for taxpayers. After R and S have collected the information from a taxpayer and applied the tax laws to the information, the return form is completed by a computer service. On the day the returns prepared by R and S are ready for their signatures, R is away from the city for 1 week on another assignment and S is on detail to another office in the same city for the day. T may sign the gift tax returns prepared by R, provided that T reviews the information obtained by R relative to the taxpayer, and T reviews the preparation of each return prepared by R. T may not sign the returns prepared by S because S is available.

(5) *Effective/applicability date*. This paragraph (b) is applicable to returns and claims for refund filed after December 31, 2008.

(c) *Failure to furnish identifying number.* (1) A person who is a signing tax return preparer as described in §301.7701–15(b)(1) of this chapter of any return of tax under the Code or claim for refund of tax under the Code, and who fails to satisfy the requirement of section 6109(a)(4) and §1.6109–2(a) to furnish one or more identifying numbers of signing tax return preparers or persons employing the signing tax return preparer (or with which the signing tax return preparer is associated) on a return or claim for refund after it is completed and before it is presented to the taxpayer (or nontaxable entity) for signature shall be subject to a penalty of $50 for each failure, with a maximum of $25,000 per person imposed with respect to each calendar year, unless it is shown that the failure is due to reasonable cause and not due to willful neglect.

(2) No more than one penalty of $50 may be imposed under section 6695(c) and paragraph (c)(1) of this section with respect to a single return or claim for refund.

(d) *Failure to retain copy or record.* (1) A person who is a signing tax return preparer as described in §301.7701–15(b)(1) of this chapter of any return of tax under the Code or claim for refund of tax under the Code, and who fails to satisfy the requirements imposed upon him or her by section 6107(b) and §1.6107–1(b) and (c) (other than the record requirement described in both §1.6107–1(b)(2) and (3)) to retain and make available for inspection a copy of the return or claim for refund, or to include the return or claim for refund in a record of returns and claims for refund and make the record available for inspection, shall be subject to a penalty of $50 for the failure, unless it is shown that the failure is due to reasonable cause and not due to willful neglect.

(2) A person may not, for returns or claims for refund presented to the taxpayers (or nontaxable entities) during each calendar year, be subject to more than $25,000 in penalties under section 6695(d) and paragraph (d)(1) of this section.

(e) *Failure to file correct information returns.* A person who is subject to the reporting requirements of section 6060 and §1.6060–1 and who fails to satisfy these requirements shall pay a penalty of $50 for each such failure, with a maximum of $25,000 per person imposed for each calendar year, unless such failure was due to reasonable cause and not due to willful neglect.

(f) *Negotiation of check.* (1) No person who is a tax return preparer as described in §301.7701–15 of this chapter may endorse or otherwise negotiate, directly or through an agent, a check (including an electronic version of a check) for the refund of tax under the Code that is issued to a taxpayer other than the tax return preparer if the person was a tax return preparer of the return or claim for refund which gave rise to the refund check. A tax return preparer will not be considered to have endorsed or otherwise negotiated a check for purposes of this paragraph (f)(1) solely as a result of having affixed the taxpayer's name to a refund check for the purpose of depositing the check into an account in the name of the taxpayer or in the joint names of the taxpayer and one or more other persons (excluding the tax return preparer) if authorized by the taxpayer or the taxpayer's recognized representative.

(2) Section 6695(f) and paragraphs (f)(1) and (3) of this section do not apply to a tax return preparer-bank that—

(i) Cashes a refund check and remits all of the cash to the taxpayer or accepts a refund check for deposit in full to a taxpayer's account, so long as the bank does not initially endorse or negotiate the check (unless the bank has made a loan to the taxpayer on the basis of the anticipated refund); or

(ii) Endorses a refund check for deposit in full to a taxpayer's account pursuant to a written authorization of the taxpayer (unless the bank has made a loan to the taxpayer on the basis of the anticipated refund).

(3) A tax return preparer-bank may also subsequently endorse or negotiate a refund check as a part of the check-clearing process through the financial system after initial endorsement or negotiation.

(4) The tax return preparer shall be subject to a penalty of $500 for each endorsement or negotiation of a check

prohibited under section 6695(f) and paragraph (f)(1) of this section.

(g) *Effective/applicability date.* This section is applicable to returns and claims for refund filed after December 31, 2008.

[T.D. 9436, 73 FR 78447, Dec. 22, 2008, as amended at 74 FR 5104, Jan. 29, 2009]

§ 1.6695–2 Tax return preparer due diligence requirements for determining earned income credit eligibility.

(a) *Penalty for failure to meet due diligence requirements.* A person who is a tax return preparer of a tax return or claim for refund under the Internal Revenue Code with respect to determining the eligibility for, or the amount of, the earned income credit (EIC) under section 32 and who fails to satisfy the due diligence requirements of paragraph (b) of this section will be subject to a penalty of $500 for each such failure.

(b) *Due diligence requirements.* A preparer must satisfy the following due diligence requirements:

(1) *Completion and submission of Form 8867*—(i) The tax return preparer must complete Form 8867, ''Paid Preparer's Earned Income Credit Checklist,'' or such other form and such other information as may be prescribed by the Internal Revenue Service (IRS), and—

(A) In the case of a signing tax return preparer electronically filing the tax return or claim for refund, must electronically file the completed Form 8867 (or successor form) with the tax return or claim for refund;

(B) In the case of a signing tax return preparer not electronically filing the tax return or claim for refund, must provide the taxpayer with the completed Form 8867 (or successor form) for inclusion with the filed tax return or claim for refund; or

(C) In the case of a nonsigning tax return preparer, must provide the signing tax return preparer with the completed Form 8867 (or successor form), in either electronic or non-electronic format, for inclusion with the filed tax return or claim for refund.

(ii) The tax return preparer's completion of Form 8867 (or successor form) must be based on information provided by the taxpayer to the tax return preparer or otherwise reasonably obtained by the tax return preparer.

(2) *Computation of credit*—(i) The tax return preparer must either—

(A) Complete the Earned Income Credit Worksheet in the Form 1040 instructions or such other form and such other information as may be prescribed by the IRS; or

(B) Otherwise record in one or more documents in the tax return preparer's paper or electronic files the tax return preparer's EIC computation, including the method and information used to make the computation.

(ii) The tax return preparer's completion of the Earned Income Credit Worksheet (or other record of the tax return preparer's EIC computation permitted under paragraph (b)(2)(i)(B) of this section) must be based on information provided by the taxpayer to the tax return preparer or otherwise reasonably obtained by the tax return preparer.

(3) *Knowledge*—(i) *In general.* The tax return preparer must not know, or have reason to know, that any information used by the tax return preparer in determining the taxpayer's eligibility for, or the amount of, the EIC is incorrect. The tax return preparer may not ignore the implications of information furnished to, or known by, the tax return preparer, and must make reasonable inquiries if the information furnished to the tax return preparer appears to be incorrect, inconsistent, or incomplete. A tax return preparer must make reasonable inquiries if a reasonable and well-informed tax return preparer knowledgeable in the law would conclude that the information furnished to the tax return preparer appears to be incorrect, inconsistent, or incomplete. The tax return preparer must also contemporaneously document in the files the reasonable inquiries made and the responses to these inquiries.

(ii) *Examples.* The provisions of paragraph (b)(3)(i) of this section are illustrated by the following examples:

Example 1. A 22 year-old taxpayer wants to claim two sons, ages 10 and 11, as qualifying children for purposes of the EIC. Preparer A must make additional reasonable inquiries regarding the relationship between the taxpayer and the children as the age of the taxpayer appears inconsistent with the ages of the children claimed as sons.

Example 2. An 18 year-old female taxpayer with an infant has $3,000 in earned income and states that she lives with her parents. Taxpayer wants to claim the infant as a qualifying child for the EIC. This information appears incomplete and inconsistent because the taxpayer lives with her parents and earns very little income. Preparer B must make additional reasonable inquires to determine if the taxpayer is the qualifying child of her parents and, therefore, ineligible to claim the EIC.

Example 3. Taxpayer asks Preparer C to prepare his tax return and wants to claim his niece and nephew as qualifying children for the EIC. Preparer C should make reasonable inquiries to determine whether the children meet EIC qualifying child requirements and ensure possible duplicate claim situations involving the parents or other relatives are properly considered.

Example 4. Taxpayer asks Preparer D to prepare her tax return and tells D that she has a Schedule C business, that she has two qualifying children and that she wants to claim the EIC. Taxpayer indicates that she earned $10,000 from her Schedule C business, but that she has no expenses. This information appears incomplete because it is very unlikely that someone who is self-employed has no business expenses. D must make additional reasonable inquiries regarding taxpayer's business to determine whether the information regarding both income and expenses is correct.

(4) *Retention of records*—(i) The tax return preparer must retain—

(A) A copy of the completed Form 8867 (or successor form);

(B) A copy of the completed Earned Income Credit Worksheet (or other record of the tax return preparer's EIC computation permitted under paragraph (b)(2)(i)(B) of this section); and

(C) A record of how and when the information used to complete Form 8867 (or successor form) and the Earned Income Credit Worksheet (or other record of the tax return preparer's EIC computation permitted under paragraph (b)(2)(i)(B) of this section) was obtained by the tax return preparer, including the identity of any person furnishing the information, as well as a copy of any document that was provided by the taxpayer and on which the tax return preparer relied to complete Form 8867 (or successor form) or the Earned Income Credit Worksheet (or other record of the tax return preparer's EIC computation permitted under paragraph (b)(2)(i)(B) of this section).

(ii) The items in paragraph (b)(4)(i) of this section must be retained for three years from the latest of the following dates, as applicable:

(A) The due date of the tax return (determined without regard to any extension of time for filing);

(B) In the case of a signing tax return preparer electronically filing the tax return or claim for refund, the date the tax return or claim for refund was filed;

(C) In the case of a signing tax return preparer not electronically filing the tax return or claim for refund, the date the tax return or claim for refund was presented to the taxpayer for signature; or

(D) In the case of a nonsigning tax return preparer, the date the nonsigning tax return preparer submitted to the signing tax return preparer that portion of the tax return or claim for refund for which the nonsigning tax return preparer was responsible.

(iii) The items in paragraph (b)(4)(i) of this section may be retained on paper or electronically in the manner prescribed in applicable regulations, revenue rulings, revenue procedures, or other appropriate guidance (see § 601.601(d)(2) of this chapter).

(c) *Special rule for firms.* A firm that employs a tax return preparer subject to a penalty under section 6695(g) is also subject to penalty if, and only if—

(1) One or more members of the principal management (or principal officers) of the firm or a branch office participated in or, prior to the time the return was filed, knew of the failure to comply with the due diligence requirements of this section;

(2) The firm failed to establish reasonable and appropriate procedures to ensure compliance with the due diligence requirements of this section; or

(3) The firm disregarded its reasonable and appropriate compliance procedures through willfulness, recklessness, or gross indifference (including ignoring facts that would lead a person of reasonable prudence and competence to

investigate or ascertain) in the preparation of the tax return or claim for refund with respect to which the penalty is imposed.

(d) *Exception to penalty.* The section 6695(g) penalty will not be applied with respect to a particular tax return or claim for refund if the tax return preparer can demonstrate to the satisfaction of the IRS that, considering all the facts and circumstances, the tax return preparer's normal office procedures are reasonably designed and routinely followed to ensure compliance with the due diligence requirements of paragraph (b) of this section, and the failure to meet the due diligence requirements of paragraph (b) of this section with respect to the particular tax return or claim for refund was isolated and inadvertent. The preceding sentence does not apply to a firm that is subject to the penalty as a result of paragraph (c) of this section.

(e) *Effective/applicability date.* This section applies to tax returns and claims for refund for tax years ending on or after December 31, 2011.

[T.D. 8905, 65 FR 61269, Oct. 17, 2000, as amended by T.D. 9436, 73 FR 78448, Dec. 22, 2008; T.D. 9570, 76 FR 78819, Dec. 20, 2011]

§ 1.6696–1 Claims for credit or refund by tax return preparers or appraisers.

(a) *Notice and demand.* (1) The Internal Revenue Service (IRS) shall issue to each tax return preparer or appraiser one or more statements of notice and demand for payment for all penalties assessed against the tax return preparer or appraiser under section 6694 and §1.6694–1, under section 6695 and §1.6695–1, or under section 6695A (and any subsequently issued regulations).

(2) For the definition of the term ''tax return preparer'', see section 7701(a)(36) and §301.7701–15 of this chapter. A person who prepares a claim for credit or refund under this section for another person, however, is not, with respect to that preparation, a tax return preparer as defined in section 7701(a)(36) and §301.7701–15 of this chapter.

(b) *Claim filed by tax return preparer or appraiser.* A claim for credit or refund of a penalty (or penalties) assessed against a tax return preparer or appraiser under section 6694 and §1.6694–1, under section 6695 and §1.6695–1, or under section 6695A (and any subsequently issued regulations) may be filed under this section only by the tax return preparer or the appraiser (or the tax return preparer's or appraiser's estate) against whom the penalty (or penalties) is assessed and not by, for example, the tax return preparer's or appraiser's employer. This paragraph (b) is not intended, however, to impose any restrictions on the preparation of this claim for credit or refund. The claim may be prepared by the tax return preparer's or appraiser's employer or by other persons. In all cases, however, the claim for credit or refund shall contain the information specified in paragraph (d) of this section and, as required by paragraph (d) of this section, shall be verified by a written declaration by the tax return preparer or appraiser that the information is provided under penalty of perjury.

(c) *Separation and consolidation of claims.* (1) Unless paragraph (c)(2) of this section applies, a tax return preparer shall file a separate claim for each penalty assessed in each statement of notice and demand issued to the tax return preparer.

(2) A tax return preparer may file one or more consolidated claims for any or all penalties imposed on the tax return preparer by a single IRS campus or office under section 6695(a) and §1.6695–1(a) (relating to failure to furnish copy of return to taxpayer), section 6695(b) and §1.6695–1(b) (relating to failure to sign), section 6695(c) and §1.6695–1(c) (relating to failure to furnish identifying number), or under section 6695(d) and §1.6695–1(d) (relating to failure to retain copy of return or record), whether the penalties are asserted on a single or on separate statements of notice and demand. In addition, a tax return preparer may file one consolidated claim for any or all penalties imposed on the tax return preparer by a single IRS campus or office under section 6695(e) and §1.6695–1(e) (relating to failure to file correct information return), which are asserted on a single statement of notice and demand.

(d) *Content of claim.* Each claim for credit or refund for any penalty (or penalties) paid by a tax return preparer under section 6694 and §1.6694–1, or under section 6695 and §1.6695–1, or paid by an appraiser under section 6695A (and any subsequently issued regulations) shall include the following information, verified by a written declaration by the tax return preparer or appraiser that the information is provided under penalty of perjury:

(1) The tax return preparer's or appraiser's name.

(2) The tax return preparer's or appraiser's identification number. If the tax return preparer or appraiser is—

(i) An individual (not described in paragraph (d)(2)(iii) of this section) who is a citizen or resident of the United States, the tax return preparer's or appraiser's social security account number (or such alternative number as may be prescribed by the IRS in forms, instructions, or other appropriate guidance) shall be provided;

(ii) An individual who is not a citizen or resident of the United States and also was not employed by another tax return preparer or appraiser to prepare the document (or documents) with respect to which the penalty (or penalties) was assessed, the tax return preparer's or appraiser's employer identification number shall be provided; or

(iii) A person (whether an individual, corporation, or partnership) that employed one or more persons to prepare the document (or documents) with respect to which the penalty (or penalties) was assessed, the tax return preparer's or appraiser's employer identification number shall be provided.

(3) The tax return preparer's or appraiser's address where the IRS mailed the statement (or statements) of notice and demand and, if different, the tax return preparer's or appraiser's address shown on the document (or documents) with respect to which the penalty (or penalties) was assessed.

(4)(i) The address of the IRS campus or office that issued the statement (or statements) of notice and demand for payment of the penalty (or penalties).

(ii) The date (or dates) and identifying number (or numbers) of the statement (or statements) of notice and demand.

(5)(i) The identification, by amount, type, and document to which related, of each penalty included in the claim. Each document referred to in the preceding sentence shall be identified by the form title or number, by the taxpayer's (or nontaxable entity's) name and taxpayer identification number, and by the taxable year to which the document relates.

(ii) The date (or dates) of payment of the amount (or amounts) of the penalty (or penalties) included in the claim.

(iii) The total amount claimed.

(6) A statement setting forth in detail—

(i) Each ground upon which each penalty overpayment claim is based; and

(ii) Facts sufficient to apprise the IRS of the exact basis of each such claim.

(e) *Form for filing claim.* Notwithstanding §301.6402–2(c) of this chapter, Form 6118, ''Claim for Refund of Tax Return Preparer and Promoter Penalties,'' is the form prescribed for making a claim as provided in this section with respect to penalties under sections 6694 and 6695. Form 843, Claim for Refund and Request for Abatement, is the form prescribed for making a claim as provided in this section with respect to a penalty under section 6695A.

(f) *Place for filing claim.* A claim filed under this section shall be filed with the IRS campus or office that issued to the tax return preparer or appraiser the statement (or statements) of notice and demand for payment of the penalty (or penalties) included in the claim.

(g) *Time for filing claim.* (1)(i) Except as provided in section 6694(c)(1) and §1.6694–4(a)(4)(ii) and (5), and in section 6694(d) and §1.6694–1(d):

(A) A claim for a penalty paid by a tax return preparer under section 6694 and §1.6694–1, or under section 6695 and §1.6695–1, or by an appraiser under section 6695A (and any subsequently issued regulations) shall be filed within three years from the date the payment was made.

(B) A consolidated claim, permitted under paragraph (c)(2) of this section, shall be filed within three years from the first date of payment of any penalty included in the claim.

(ii) For purposes of this paragraph (g)(1), payment is considered made on the date payment is received by the

IRS or, if applicable, on the date an amount is credited in satisfaction of the penalty.

(2) For purposes of determining whether a claim is timely filed, the rules under sections 7502 and 7503 and the provisions of §§1.7502–1, 1.7502–2, and 1.7503–1 apply.

(h) *Application of refund to outstanding liability of tax return preparer or appraiser*. The IRS may, within the applicable period of limitations, credit any amount of an overpayment by a tax return preparer or appraiser of a penalty (or penalties) paid under section 6694 and §1.6694–1, under section 6695 and §1.6695–1, or under section 6695A (and any subsequently issued regulations) against any outstanding liability for any tax (or for any interest, additional amount, addition to the tax, or assessable penalty) owed by the tax return preparer or appraiser making the overpayment. If a portion of an overpayment is so credited, only the balance will be refunded to the tax return preparer or appraiser.

(i) *Interest*. (1) Section 6611 and §301.6611–1 of this chapter apply to the payment by the IRS of interest on an overpayment by a tax return preparer or appraiser of a penalty (or penalties) paid under section 6694 and §1.6694–1, under section 6695 and §1.6695–1, or under section 6695A (and any subsequently issued regulations).

(2) Section 6601 and §301.6601–1 of this chapter apply to the payment of interest by a tax return preparer or appraiser to the IRS on any penalty (or penalties) assessed against the tax return preparer under section 6694 and §1.6694–1, under section 6695 and §1.6695–1, or under section 6695A (and any subsequently issued regulations).

(j) *Suits for refund of penalty*. (1) A tax return preparer or appraiser may not maintain a civil action for the recovery of any penalty paid under section 6694 and §1.6694–1, under section 6695 and §1.6695–1, or under section 6695A (and any subsequently issued regulations), unless the tax return preparer or appraiser has previously filed a claim for credit or refund of the penalty as provided in this section (and the court has jurisdiction of the proceeding). See sections 6694(c) and 7422.

(2)(i) Except as provided in section 6694(c)(2) and §1.6694–4(b), the periods of limitation contained in section 6532 and §301.6532–1 of this chapter apply to a tax return preparer's or appraiser's suit for the recovery of any penalty paid under section 6694 and §1.6694–1, under section 6695 and §1.6695–1, or under section 6695A (and any subsequently issued regulations).

(ii) The rules under section 7503 and §301.7503–1 of this chapter apply to the timely commencement by a tax return preparer or appraiser of a suit for the recovery of any penalty paid under section 6694 and §1.6694–1, under section 6695 and §1.6695–1, or under section 6695A (and any subsequently issued regulations).

(k) *Effective/applicability date*. This section is applicable to returns and claims for refund filed, and advice provided, after December 31, 2008.

[T.D. 9436, 73 FR 78449, Dec. 22, 2008, as amended at 74 FR 5105, Jan. 29, 2009]

§1.6709–1T Penalties with respect to mortgage credit certificates (temporary).

(a) *Material misstatement*—(1) *Negligence*. If any person makes a material misstatement in any affidavit or other statement under a penalty of perjury made with respect to the issuance of a mortgage credit certificate and such misstatement is due to the negligence of that person, that person shall pay a penalty of $1,000 for each mortgage credti certificate with respect to which that misstatement was made.

(2) *Fraud*. If a misstatement described in subparagraph (1) is due to fraud on the part of the person making the misstatement, that person shall pay a penalty of $10,000 for each mortgage credit certificate with respect to which the fraudulent misstatement was made. The penalty imposed by this paragraph (a)(2) is in addition to any criminal penalty.

(b) *Reports*. (1) Any person required by §1.25–8T to file a report with respect to any mortgage credit certificate who fails to file the report at the time and in the manner required by §1.25–8T shall pay a penalty of $200 for each mortgage credit certificate with respect to which that failure occurred. The preceding sentence shall not apply if it is shown that such failure is due to reasonable cause and not to willful neglect.

(2) In the case of any report required under § 1.25–8T(b), the aggregate amount of the penalty imposed by this paragraph shall not exceed $2,000.

[T.D. 8023, 50 FR 19355, May 8, 1985]

JEOPARDY, BANKRUPTCY, AND RECEIVERSHIPS

§ 1.6851–1 Termination assessments of income tax.

(a) *Authority for making*—(1) *In general.* This section applies to assessments authorized by a district director under section 6851(a) (hereinafter referred to as termination assessments). The district director shall immediately authorize a termination assessment of the income tax for the current or preceding taxable year if the district director finds that a taxpayer designs to do an act which would tend to prejudice proceedings to collect the income tax for such year or years unless such proceedings are brought without delay. In addition, the district director shall immediately authorize such a termination assessment if the district director determines that the taxpayer designs to do any act which would tend to render such proceedings wholly or partially ineffective unless brought without delay. A termination assessment will be made if collection is determined to be in jeopardy because at least one of the following conditions exists.

(i) The taxpayer is or appears to be designing quickly to depart from the United States or to conceal himself or herself.

(ii) The taxpayer is or appears to be designing quickly to place his, her, or its property beyond the reach of the Government either by removing it from the United States, by concealing it, by dissipating it, or by transferring it to other persons.

(iii) The taxpayer's financial solvency is or appears to be imperiled.

Paragraph (a)(1)(iii) of this section does not include cases where the taxpayer becomes insolvent by virtue of the accrual of the proposed assessment of tax, and penalty, if any. A tax assessed under this section shall become immediately due and payable and the district director shall serve upon such taxpayer notice and demand for immediate payment of such tax.

(2) *Computation of tax.* If a termination assessment of the income tax for the current year is made, the income tax for such year shall be computed for the period beginning on the first day of such year and ending on the day of the assessment. A credit shall be allowed for any tax for the taxable year previously assessed under section 6851. The taxpayer is entitled to a deduction for the personal exemptions (as limited in the case of certain non-resident aliens) without any proration for or because of the short taxable period.

(3) *Taxable year not affected by termination.* Notwithstanding any termination assessment a taxpayer shall file a return in accordance with section 6012 and the regulations thereunder for the taxpayer's full taxable year. The term ''full taxable year'' means the taxpayer's usual annual accounting period determined without regard to any action under section 6851 and this section. The return shall show all items of gross income, deductions, and credits for such taxable year. Any tax collected as a result of a termination assessment will be applied against the tax due for the taxpayer's full taxable year. Except as provided in § 1.6851–2 (relating to departing aliens), no return is required to be filed for a terminated period other than a full taxable year.

(4) *Evidence of compliance with income tax obligations.* Citizens of the United States or of possessions of the United States departing from the United States or its possessions will not be required to procure certificates of compliance or to present any other evidence of compliance with income tax obligations. However, for the rules relating to the furnishing of evidence of compliance with the income tax obligations by certain departing aliens, see § 1.6851–2.

(5) *Section 6851 inapplicable where section 6861 applies.* No termination assessment for the preceding taxable year shall be made after the due date of the taxpayer's return for such year (determined with regard to extensions of time to file such return).

(b) *Notice of deficiency.* Where notice and demand for payment (following a termination assessment) takes place after February 28, 1977, the district director shall, within 60 days after the later of:

(1) The date the taxpayer files a return for the full taxable year; or

(2) The due date of such return (determined with regard to extensions); send the taxpayer a notice of deficiency under section 6212(a). The amount of the deficiency shall be computed in accordance with section 6211 and the regulations thereunder. In applying section 6211, the tax imposed and the amount shown upon the return shall be determined on the basis of the taxpayer's full taxable year. Thus, for example assume that on November 1, 1979, a termination assessment against A, a calendar year taxpayer, is made in the amount of $18,000. The termination assessment is for the period from January 1, 1979 through November 1, 1979. Further assume that on or before April 15, 1980, A files a form 1040 showing an income tax liability for the full year 1979 of $10,000. If the district director determines A's liability for tax for 1979 is $16,000, a notice of deficiency for $6,000 shall be sent to A on or before June 14, 1980. Assuming that the district director had collected the $18,000 assessed, $2,000 shall be refunded.

(c) *Immediate payment.* The district director shall make demand for immediate payment of the amount of the termination assessment, and the taxpayer shall immediately pay such amount or shall immediately file the bond provided in section 6863.

(d) *Abatement.* The provisions of §§ 301.6861–1(e) and 301.6861–1(f) relating to the abatement of jeopardy assessments, shall apply to assessments made under section 6851.

[T.D. 7575, 43 FR 58816, Dec. 18, 1978]

§ 1.6851–2 Certificates of compliance with income tax laws by departing aliens.

(a) *In general*—(1) *Requirement.* The rules of this section are applicable, except as otherwise expressly provided, to any alien who departs from the United States or any of its possessions after January 20, 1961. Except as provided in subparagraph (2) of this paragraph, no such alien, whether resident or nonresident, may depart from the United States unless he first procures a certificate that he has complied with all of the obligations imposed upon him by the income tax laws. In order to procure such a certificate, an alien who intends to depart from the United States (i) must file with the district director for the internal revenue district in which he is located the statements or returns required by paragraph (b) of this section to be filed before obtaining such certificate, (ii) must appear before such district director if the district director deems it necessary, and (iii) must pay any taxes required under paragraph (b) of this section to be paid before obtaining the certificate. Either such certificate of compliance, properly executed, or evidence that the alien is excepted under subparagraph (2) of this paragraph from obtaining the certificate must be presented at the point of departure. An alien who presents himself at the point of departure without a certificate of compliance, or evidence establishing that such a certificate is not required, will be subject at such departure point to examination by an internal revenue officer or employee and to the completion of returns and statements and payment of taxes as required by paragraph (b) of this section.

(2) *Exceptions*—(i) *Employees of foreign governments or international organizations—(a) Diplomatic representatives, their families and servants.* (*1*) Representatives of foreign governments bearing diplomatic passports, whether accredited to the United States or other countries, and members of their households shall not, upon departure from the United States or any of its possessions, be examined as to their liability for United States income tax or be required to obtain a certificate of compliance. If a foreign government does not issue diplomatic passports but merely indicates on passports issued to members of its diplomatic service the status of the bearer as a member of such service, such passports are considered as diplomatic passports for income tax purposes.

(*2*) Likewise, the servant of a diplomatic representative who accompanies any individual bearing a diplomatic passport upon departure from the United States or any of its possessions shall not be required, upon such departure, to obtain a certificate of compliance or to submit to examination as to his liability for United States income tax. If the departure of such a servant from the United States or any of its possessions is not made in the company of an individual bearing a diplomatic passport, the servant is required to obtain a certificate of compliance. However, such certificate will be issued to him on Form 2063 without examination as to his income tax liability upon presentation to the district director for the internal revenue district in which the servant is located of a letter from the chief of the diplomatic mission to which the servant is attached certifying (*i*) that the name of the servant appears on the ''White List'', a list of employees of diplomatic missions, and (*ii*) that the servant is not obligated to the United States for any income tax, and will not be so obligated up to and including the intended date of departure.

(*b*) *Other employees.* Any employee of an international organization or of a foreign government (other than a diplomatic representative to whom (*a*) of this subdivision applies) whose compensation for official services rendered to such organization or government is excluded from gross income under section 893 and who has received no gross income from sources within the United States, and any member of his household who has received no gross income from sources within the United States, shall not, upon departure from the United States or any of its possessions after November 30, 1962, be examined as to his liability for United States income tax or be required to obtain a certificate of compliance.

(*c*) *Effect of waiver.* An alien who has filed with the Attorney General the waiver provided for under section 247(b) of the Immigration and Nationality Act (8 U.S.C. 1257(b)) is not entitled to the exception provided by this subdivision.

(ii) *Alien students, industrial trainees, and exchange visitors.* A certificate of compliance shall not be required, and examination as to United States income tax liability shall not be made, upon the departure from the United States or any of its possessions of—

(A) An alien student, industrial trainee, or exchange visitor, and any spouse and children of that alien, admitted solely on an F–1, F–2, H–3, H–4, J–1 or J–2 visa, who has received no gross income from sources inside the United States other than—

(*1*) Allowances to cover expenses incident to study or training in the United States (including expenses for travel, maintenance, and tuition);

(*2*) The value of any services or accommodations furnished incident to such study or training;

(*3*) Income derived in accordance with the employment authorizations in 8 CFR 274a.12(b) and (c) that apply to the alien's visa; or

(*4*) Interest on deposits described in section 871(i)(2)(A); or

(B) An alien student, and any spouse or children of that alien admitted solely on an M–1 or M–2 visa, who has received no gross income from sources inside the United States other than income derived in accordance with the employment authorization in 8 CFR 274a.12(c)(6) or interest on deposits described in section 871(i)(2)(A).

(iii) *Other aliens temporarily in the United States.* A certificate of compliance shall not be required, and examination as to United States income tax liability shall not be made, upon the departure from the United States or any of its possessions of an alien hereinafter described in this subdivision, unless the district director has reason to believe that such alien has received taxable income during the taxable year up to and including the date of departure or during the preceding taxable year and that collection of income tax from such alien will be jeopardized by his departure from the United States:

(*a*) An alien visitor for pleasure admitted solely on a B–2 visa;

(*b*) An alien visitor for business admitted on a B–1 visa, or on both a B–1 visa and a B–2 visa, who does not remain in the United States or a possession thereof for a period or periods exceeding a total of 90 days during the taxable year;

(*c*) An alien in transit through the United States or any of its possessions on a C–1 visa or under a contract, including a bond agreement, between a transportation line and the Attorney General pursuant to section 238(d) of the Immigration and Nationality Act (8 U.S.C. 1228(d));

(*d*) An alien who is admitted to the United States on a border-crossing identification card or with respect to whom passports, visas, and border-crossing identification cards are not required, if such alien is a visitor for pleasure, or if such alien is a visitor for business who does not remain in the United States or a possession thereof for a period or periods exceeding a total of 90 days during the taxable year, or if such alien is in transit through the United States or any of its possessions;

(*e*) An alien military trainee admitted to the United States to pursue a course of instruction under the auspices of the Department of Defense who departs from the United States on official military travel orders; or

(*f*) An alien resident of Canada or Mexico who commutes between such country and the United States at frequent intervals for the purpose of employment and whose wages are subject to the withholding of tax.

(b) *Issuance of certificate of compliance*—(1) *In general.* (i) Upon the departure of an alien required to secure a certificate of compliance under paragraph (a) of this section, the district director shall determine whether the departure of such alien jeopardizes the collection of any income tax for the current or the preceding taxable year, but the district director may determine that jeopardy does not exist in some cases. If the district director finds that the departure of such an alien results in jeopardy, the taxable period of the alien will be terminated, and the alien will be required to file returns and make payment of tax in accordance with subparagraph (3)(iii) of this paragraph. On the other hand, if the district director finds that the departure of the alien does not result in jeopardy, the alien will be required to file the statement or returns required by subparagraph (2) or (3)(ii) of this paragraph, but will not be required to pay income tax before the usual time for payment.

(ii) The departure of an alien who is a resident of the United States or a possession thereof (or treated as a resident under section 6013 (g) or (h)) and who intends to continue such residence (or treatment as a resident) shall be treated as not resulting in jeopardy, and thus not requiring termination of his taxable period, except when the district director has information indicating that the alien intends by such departure to avoid the payment of his income tax. In the case of a nonresident alien (including a resident alien discontinuing residence), the fact that the alien intends to depart from the United States will justify termination of his taxable period unless the alien establishes to the satisfaction of the district director that he intends to return to the United States and that his departure will not jeopardize collection of the tax. The determination of whether the departure of the alien results in jeopardy will be made on examination of all the facts in the case. Evidence tending to establish that jeopardy does not result from the departure of the alien may be provided, for example, by information showing that the alien is engaged in trade or business in the United States or that he leaves sufficient property in the United States to secure payment of his income tax for the taxable year and of any income tax for the preceding year which remains unpaid.

(2) *Alien having no taxable income and resident alien whose taxable period is not terminated.* A statement on Form 2063 shall be filed with the district director by every alien required to obtain a certificate of compliance:

(i) Who is a resident of the United States and whose taxable period is not terminated either because he has had no taxable income for the taxable year up to and including the date of his departure (and for the preceding taxable year where the period for making the income tax return for such year has not expired) or because, although he has had taxable income for such period or periods, the district director has not found that this departure jeopardizes collection of the tax on such income; or

(ii) Who is not a resident of the United States and who has had no taxable income for the taxable year up to and including the date of his departure (and for the preceding taxable year where the period for making the income tax return for such year has not expired).

Any alien described in subdivision (i) or (ii) of this subparagraph who is in default in making return of, or paying, income tax for any taxable year shall, in addition, file with the district director any returns which have not been made as required and pay to the district director the amount of any tax for which he is in default. Upon compliance by an alien with the foregoing requirements of this subparagraph, the district director shall execute and issue to the alien the certificate of compliance attached to Form 2063. The certificate of compliance so issued shall be effective for all departures of the alien during his current taxable year, subject to revocation upon any subsequent departure should the district director have reason to believe that such subsequent departure would result in jeopardy. The statement required of a resident alien under this subparagraph, if made before January 21, 1961, with respect to a departure after January 20, 1961, may be made on a Form 1040C in lieu of a Form 2063.

(3) *Nonresident alien having taxable income and resident alien whose taxable period is terminated*—(i) *Nonresident alien having taxable income.* Every nonresident alien required to obtain a certificate of compliance (but not described in subparagraph (2) of this paragraph) who wishes to establish that his departure does not result in jeopardy shall furnish to the district director such information as may be required for the purpose of determining whether the departure of the alien jeopardizes collection of the income tax and thus requires termination of his taxable period.

(ii) *Nonresident alien whose taxable period is not terminated.* Every nonresident alien described in subdivision (i) of this subparagraph whose taxable period is not terminated upon departure shall file with the district director:

(*a*) A return in duplicate on Form 1040C for the taxable year of his intended departure, showing income received, and reasonably expected to be received, during the entire taxable year within which the departure occurs; and

(*b*) Any income tax returns which have not been filed as required.

Upon compliance by the alien with the foregoing requirements of this subdivision, and the payment of any income tax for which he is in default, the district director shall execute and issue to the alien the certificate of compliance on the duplicate copy of Form 1040C. The certificate of compliance so issued shall be effective for all departures of the alien during his current taxable year, subject to revocation by the district director upon any subsequent departure if the taxable period of the alien is terminated on such subsequent departure.

(iii) *Alien (whether resident or nonresident) whose taxable period is terminated.* Every alien required to obtain a certificate of compliance, whether resident or nonresident, whose taxable period is terminated upon departure shall file with the district director:

(*a*) A return in duplicate on Form 1040C for the short taxable period resulting from such termination, showing income received, and reasonably expected to be received, during the taxable year up to and including the date of departure;

(*b*) Where the period for filing has not expired, the return required under section 6012 and §1.6012–1 for the preceding taxable year; and

(*c*) Any other income tax returns which have not been filed as required.

Upon compliance with the foregoing requirements of this subdivision, and payment of the income tax required to be shown on the returns filed pursuant to (*a*) and (*b*) of this subdivision and of any income tax due and owing for prior years, the departing alien will be issued the certificate of compliance on the duplicate copy of Form 1040C. The certificate of compliance so issued shall be effective only for the specific departure with respect to which it is issued. A departing alien may postpone payment of the tax required to be shown on the returns filed in accordance with (*a*) and (*b*) of this subdivision until the usual time of payment by furnishing a bond as provided in §301.6863–1.

(4) *Joint return on Form 1040C.* A departing alien may not file a joint return on Form 1040C unless:

(i) Such alien and his spouse may reasonably be expected to be eligible to file a joint return at the normal close of their taxable periods for which the return is made; and

(ii) If the taxable period of such alien is terminated, the taxable periods of both spouses are so terminated as to end at the same time.

(5) *Annual return.* Notwithstanding that Form 1040C has been filed for either the entire taxable year of departure or for a terminated period, the return required under section 6012 and §1.6012–1 for such taxable year shall be filed. Any income tax paid on income shown on the return on Form 1040C shall be applied against the tax determined to be due on the income required to be shown on the subsequent return under section 6012 and §1.6012–1.

[T.D. 6537, 26 FR 547, Jan. 20, 1961, as amended by T.D. 6620, 27 FR 11803, Nov. 30, 1962; T.D. 7575, 43 FR 58817, Dec. 18, 1978; T.D. 7670, 45 FR 6931, Jan. 31, 1980; T.D. 8332, 56 FR 3034, Jan. 28, 1991; T.D. 8526, 59 FR 10067, Mar. 3, 1994]

§ 1.6851–3 Furnishing of bond to insure payment; cross reference.

See section 6863 and §301.6863–1 of this chapter (regulations on procedure and administration) for rules relating to the furnishing of bond to stay collection.

[T.D. 7575, 43 FR 58817, Dec. 18, 1978]

THE TAX COURT

DECLARATORY JUDGMENTS RELATING TO QUALIFICATION OF CERTAIN RETIREMENT PLANS

§ 1.7476–1 Interested parties.

(a) *In general*—(1) *Notice requirement.* Before the Internal Revenue Service can issue an advance determination as to the qualified status of certain retirement plans, the applicant must provide the Internal Revenue Service with satisfactory evidence that such applicant has notified the persons who qualify as interested parties, under regulations prescribed under section 7476(b)(1) of the Code, of the application for such determination. See section 3001(a) of the Employee Retirement Income Security Act of 1974 (88 Stat. 995). For the rules for giving notice to interested parties, see §1.7476–2 and paragraph (o) of §601.201 of this chapter (Statement of Procedural Rules).

(2) *Declaratory judgments.* Section 7476 provides a procedure for obtaining a declaratory judgment by the Tax Court with respect to the initial or continuing qualification under subchapter D of chapter 1 of the Code of a retirement plan defined in section 7476(d), in the case of an actual controversy involving:

(i) A determination by the Internal Revenue Service with respect to the initial qualification or continuing qualification under such subchapter of such a plan, or

(ii) A failure by the Internal Revenue Service to make a determination with respect to:

(A) Such initial qualification of such a plan, or

(B) Such continuing qualification of such a plan, if the controversy arises from a plan amendment or plan termination.

Under section 7476(d) the term ''retirement plan'' means a pension profitsharing, or stock bonus plan described in section 401(a), or a trust which is part of such a plan, an annuity plan described in section 403(a), or a bond purchase plan described in section 405(a). This procedure is available only to the employer, the plan administrator as defined in section 414(g), an employee who qualifies as an interested party as defined in this section, or the Pension Benefit Guaranty Corporation, where such person has an actual controversy involving a determination described in paragraph (a)(2)(ii) of this section. In the case of an application for such a determination, this procedure is available only if such determination or failure to make such determination is with respect to an application described in paragraph (b)(7) of this section. In addition, in the case of such an application, if a petitioner was the applicant for the determination, the Tax Court may hold, under section 7476(b)(2), the filing of a pleading for a declaratory judgment to be premature unless the petitioner establishes to the satisfaction of the Tax